

# "Active Business" as a Technique of Source Discrimination in the Formulation of Corporate Tax Policy

Kathleen A. Lahey

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# "ACTIVE BUSINESS" AS A TECHNIQUE OF SOURCE DISCRIMINATION IN THE FORMULATION OF CORPORATE TAX POLICY

By KATHLEEN A. LAHEY\*

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The present active business provisions are the culmination of sixty years of legislative development. In order to present the considerations which have combined to require a distinction between "active" and "passive" business income in current federal income tax legislation, the first part of this article sketches the evolution of that concept through the 1972 amendments of the *Income Tax Act*. Part II examines the social and economic purposes intended to be effected by the present sections 95 and 125 and the role that the active business device plays in achieving those purposes. The last part analyses administrative and judicial interpretations of active business in terms of their consistency with perceived policy objectives as well as their substantive description of the term.

## I. ORIGIN AND DEVELOPMENT OF ACTIVE BUSINESS PROVISIONS

Two fundamental problems confront the architect of corporate tax statutes: preventing taxpayers from using the fact of incorporation to shelter income from personal investments, personal services, contributions from a spouse or professional activities from high personal rates of taxation, and preventing taxpayers from accumulating income from sheltered sources by leaving it in the corporation as undistributed surplus. While other abuses will develop in response to a given scheme of corporate taxation, these two points are central to any system which recognizes the independent legal personality of the corporation and its shareholders, and they have been accorded increasingly sophisticated treatment in Canadian tax legislation. Continuing reliance on the concept of active business to counter these abuses is evident in the development of corporate tax legislation.

Active business has also gained currency as a technique of distinguishing business and investment incomes of corporations for purposes of differentiating the tax treatment of those incomes, not to counter tax avoidance, but to achieve social and economic objectives as well as objectives of tax equity and neutrality. This use of active business in legislation governing extraterritorial corporate operations is a recent development.

### A. *Active Business And Domestic Corporations*

#### 1. Income War Tax Act

When the *Income War Tax Act*<sup>1</sup> was first enacted in Canada, no attempt was made to differentiate the business corporation from the so-called "incorporated pocketbook" for tax purposes, nor were classes of corporate sources subjected to segregated treatment. Section 3(1) of the original act did contain a cryptic reference to undivided and undistributed gains and profits<sup>2</sup> in the extended definition of income, but that language was never construed as bring-

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<sup>1</sup> S.C. 1917, c. 28.

<sup>2</sup> Section 3(1) provided: "For the purposes of this Act, 'income' . . . shall include . . . dividends or profits . . . received . . . from stocks, . . . whether such gains or profits are divided or distributed or not . . ."

ing undistributed income of a corporation into the income of its shareholders.<sup>3</sup> There was, therefore, no attempt made in the *Income War Tax Act* to reserve the tax benefits of incorporation for a particular class of income-producing operations.

Unreasonable accumulations were dealt with directly. Section 3(4) conferred upon the Minister the power to allocate accumulated income to shareholders where there was no valid business purpose for the accumulation.<sup>4</sup> Surprisingly, there are no reported decisions which discuss the effect of this provision at all, and no evidence upon which to assess its impact on incorporated investments. Taking the United States experience as a guideline, an excess accumulations provision can be a powerful tool in counteracting the use of corporations as tax shelters.<sup>5</sup>

Whatever the efficacy of the accumulations provision in the *Income War Tax Act*, it was superseded in 1926 by two very pointed provisions which sought to deal with the related problems of sheltering investment income by incorporation and double taxation of incorporated small businesses. The "family corporation" concept provided that an actively operated corporation would pay only one layer of taxation by permitting the shareholders to elect to be taxed as if the corporation were a partnership, in effect transforming the separate legal entity of the corporation into a "conduit pipe" for all income of the corporation in each taxation year. One interesting limitation on the availability of the election was that dominating shareholders had to "take an active part in" or be "actively employed in the business of the corporation."<sup>6</sup> In domestic corporate legislation, this is the earliest attempt to differentiate in-

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<sup>3</sup> The issue was not pressing because section 3(1)(d) of the *Income War Tax Act* exempted dividend income from the normal tax.

<sup>4</sup> The original version of section 3(4) provided for inclusion of undistributed profits "unless the Minister is of opinion that the accumulation . . . is not made for the purpose of evading the tax, and is not in excess of what is reasonably required for the purposes of the business". S.C. 1919, c. 55, s. 2(3) modified the discretionary clause in section 3(4) to provide that undistributed income would *not* be included in taxable income unless the accumulation was in excess of reasonable business requirements and was for the purpose of evading the tax. The excessive accumulations provision was dropped in the 1948 revision.

<sup>5</sup> It is intriguing to note that the accumulated earnings tax imposed on corporations under section 531 of the *Internal Revenue Code of 1954* originated as a provision very similar in language to section 13 of the *Income War Tax Act*, including the notion of a deemed dividend of excess accumulations to shareholders. The American approach is strengthened by section 533(b) which provides that "a mere holding or investment company" will be deemed to be accumulating profits "beyond the reasonable needs of the business" and therefore engaged in avoiding the income tax on its shareholders. See generally Bittker and Eustice, *Federal Income Taxation of Corporations and Shareholders* (3d ed. Boston: Warren, Gorham & Lamont, 1971) at 8-1 to 8-51; D. Kahn, *Basic Corporate Taxation* (2d ed. Ann Arbor: Institute of Continuing Legal Education, 1973) at 171-72, 201-07.

<sup>6</sup> *Income War Tax Act*, R.S.C. 1927, c. 97, ss. 2(1)(d), 1(1),(3). In order for the election to be valid, certain conditions had to be met: 75% of the shares had to be owned by one family and at least one family member had to actively participate in the operations, or 80% of the shares had to be owned by persons "actively employed in the business."

corporated business operations from mere investment operations. The meaning of "active" in this context never received explication.<sup>7</sup>

The personal corporation was introduced along with the family corporation,<sup>8</sup> and it was this provision that was designed to counter the use of corporations to shelter the accumulation of investment income from escalating rates of personal taxation. The assumption that a family corporation provision was intended to apply to corporations which had little or no investment income is strengthened by the definition of the family corporation as "other than a personal corporation,"<sup>9</sup> because a personal corporation was defined as a corporation which derived more than twenty-five percent of its receipts from investments. At the time of their introduction and for the short time during their joint lives, then, the family and personal corporation provisions yielded these results: (1) the family corporation election was available to a corporation the business of which was "actively" conducted by one or more shareholders; (2) the family corporation election was also available to a corporation which met the test in (1) even if less than twenty-five percent of its income was from specified investments; (3) family corporation and ordinary corporation treatment was automatically denied a corporation which met the personal corporation definition, even if a substantial part of its income came from the conduct of a *bona fide* business undertaking.

## 2. The Personal Corporation Era

This short list of possibilities reflects the fact that the draftsmen had a singleminded view of the small corporation, expecting that it be used either for investment or for business, but not for both at the same time, although

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<sup>7</sup> McGregor refers to section 22 of the *Income War Tax Act* as containing a requirement that the corporation carry on "an active business," but in fact the provision had no such requirement; to qualify as a family corporation, certain of the shareholders were required to "take an active part in the business operations of the corporation" or be persons "actively employed in the business of the corporation." While this language certainly does suggest that the operations of the corporation must constitute a business and not mere investment, it does not follow that the business must be an "active business" unless one accepts the proposition that in the context of corporate income, "active business" serves the same function as does the use of the term "business" in classifying an unincorporated taxpayer's sources of income. See G. McGregor, *Personal Corporations* (Toronto: Canadian Tax Foundation, 1960) at 2-5.

<sup>8</sup> *Income War Tax Act*, S.C. 1926, c. 10, s. 3(10)(a), (b) provided as follows:

3(10)(a) For the purposes of this Act a 'personal corporation' means a corporation or joint stock company . . . controlled directly or indirectly by one person who resides in Canada, . . . the gross revenue of which is to the extent of one-quarter or more derived from one or more of the following sources, namely:—

from the ownership of or the trading or dealing in bonds, stocks or shares, debentures, mortgages, hypothecs, bills, notes or other similar property, or from the lending of money with or without security, or by way of rent, annuity, royalty, interest or dividend, or from or by virtue of any right, title or interest in or to any estate or trust.

(b) The income of a personal corporation . . . shall be deemed to be distributed as a dividend to the shareholders thereof and shall in their hands constitute taxable income for each year . . . whether actually distributed by way of dividend or not.

<sup>9</sup> *Income War Tax Act*, S.C. 1927, c. 97, s. 2(1)(d).

up to twenty-four percent of the family corporation's income could be from investment without disqualifying it. Even this slight recognition of the sometimes mixed uses of a small corporation disappeared from the *Income War Tax Act*, however, when the family corporation was abolished in 1932.<sup>10</sup> From 1933 until 1949 the only significant feature of the taxation of small corporations was the personal corporation provision. The only option of a private or closely held corporation during that period was the personal corporation provision, which applied automatically to any corporation which derived twenty-five percent or more of its income from the specified sources. As personal rates of taxation became increasingly onerous, classification as a personal corporation ceased to be an advantage and took on the character of a penalty, especially in those cases where the formation of the corporation was motivated not by a desire to shelter accumulations, but to provide an efficient enterprise form which for one reason or another might have some investment income in a given year.

Part of the crudeness of the personal corporation device was eliminated in 1940 with the introduction of the "active business" requirement, which operated to exempt from the mandatory personal corporation provision those corporations which carried on "an active financial, commercial or industrial business."<sup>11</sup> It is clear that such a qualification would operate to prevent a corporation which was more than an "incorporated pocketbook" to escape treatment as a personal corporation if its investment income rose above the permissible level, but it is also clear that the "either-or" mentality of the draftsman had simply reversed the inequities. Instead of achieving an unintended result where a business corporation received too much investment income in a given year, it was possible for an investment corporation to slip out of classification as a personal corporation by accidental or intentional acquisition of an active business.<sup>12</sup> Thus a corporation which otherwise fell to be classified as a personal corporation was either treated as an ordinary corporation if it had some active business, or ignored for tax purposes if it had no active business and derived at least twenty-five percent of its income from specified investment sources.

### 3. Personal Corporations and Tax-paid Surplus

The disparity of treatment accorded the ostensible business corporation

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<sup>10</sup> The family corporation provision was repealed only a few years after its enactment. S.C. 1932, c. 43, s. 80. For the rationale for its implementation and repeal, see McGregor, *supra* note 7.

<sup>11</sup> S.C. 1940, c. 34 added the requirement that the corporation not have an "active commercial or industrial business." By S.C. 1942, c. 28 the phrase was expanded to its mature form: "active financial, commercial or industrial business."

<sup>12</sup> See *Glaspie v. MNR*, 63 D.T.C. 828 (T.A.B.) for an illustration of a corporation's failure to take itself outside the operation of the personal corporation provision by acquisition of an active business. The Board ruled that operation of a cigar store for two weeks at a net loss of \$94.00 did not constitute an "active financial, commercial or industrial business." This decision had to have been motivated by antiavoidance considerations, for there was no *de minimus* clause in the personal corporation provision.

and the investment corporation<sup>13</sup> was further exaggerated by the introduction of graduated rates of corporate taxation. The initial provision imposed a ten percent tax on the first \$10,000 of corporate income from whatever source derived.<sup>14</sup> With marginal rates of personal taxation rising as high as eighty percent compared with a low rate of ten percent for an ordinary corporation, the concept of "active financial, commercial or industrial business" assumed crucial importance for the shareholders of small or closely held corporations. From 1952 to 1972, the amount of corporate income which was eligible for a lower rate of tax continued to increase, until the rate was twenty-one percent on the first \$35,000 and forty-seven percent on the excess.<sup>15</sup>

The gulf between the tax treatment of the ordinary business corporation and the personal corporation was further widened by the introduction of "tax-paid surplus." Not content with accumulation of profits beyond the actual needs of the corporation, shareholders of corporations which managed to avoid classification as personal corporations eventually began to view retained surpluses of their corporations as nontaxable accretions to capital which ought to be distributable tax-free, not as income in the ordinary sense. In response to this delusion, and in an attempt to coax some of this petrified surplus back into circulation, "tax-paid surplus" provisions were enacted, at first temporarily and then permanently.<sup>16</sup>

By the end of this phase, and during the years when tax reform was under consideration, the scheme under which the Canadian close corporation was taxed consisted of four principal elements: a low rate of twenty-one percent on the first \$35,000 of the taxable income of a corporation—which reduced rate was available to a public or private corporation without regard to size; a dividend tax credit to shareholders equal to twenty percent of the amount of dividends received to encourage distribution rather than accumula-

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<sup>13</sup> Not to be confused with "investment companies" which derived almost all their income from investment in stocks, bonds and securities. These companies were exempted from the corporate layer of taxation on different terms. See *Income Tax Act*, S.C. 1952, c. 148, ss. 52(1)(l), 62; formerly *Income War Tax Act*, S.C. 1927, c. 97, ss. 4(w), 9(8).

<sup>14</sup> *Income Tax Act*, S.C. 1948, c. 52, s. 36, as amended by S.C. 1949, c. 25, s. 9. The corporate rate under this new regime was 10% on the first \$10,000 of income and 33% of the excess over \$10,000. The lower rate of corporate tax was, of course, inapplicable to personal corporations, as they were exempt from all corporate taxation.

<sup>15</sup> *Income Tax Act*, S.C. 1952, c. 148, s. 39(1)(a), (b), as amended. At that time the top marginal rate was 80%.

<sup>16</sup> From 1930 through 1934, surpluses accumulated before 1930 could be distributed to shareholders without incurring tax liability, so long as the corporation paid a special 15% tax on the surplus before distribution. S.C. 1945, c. 23, s. 95 provided another opportunity for distributions of tax-paid surplus in the years 1945 through 1947, this time pertaining to surpluses accumulated through 1939. The rate of tax paid by the corporation, again, was nominal, ranging from 15% to 35%. The 1948 Act was amended by S.C. 1950, c. 40, s. 30 to make permanent the election to convert undistributed income on hand to tax-paid undistributed surplus by payment of a preferential rate of tax. Section 957 of the 1948 Act was renumbered section 105 in the 1952 revision, R.S.C. 1952, c. 148, and the section has been perpetuated in sections 82 and 196 of the 1972 Act, under which pre-1972 surpluses can be cleared out at preferential rates. Note that Bill C-56 proposes the abolition of this system by 1978.

tion of surplus; a flat fifteen percent tax payable by the corporation on after-tax surpluses accumulated in taxation years prior to 1949, the payment of that tax then enabling the corporation to make a tax-free distribution of that surplus to shareholders; and a personal corporation provision which put controlling shareholders of corporations which derived most of their income from investments in the same tax position as those individuals who held investments directly.<sup>17</sup>

#### 4. The 1972 Amendments

Whereas the scheme under the 1952 Act did not effectively discriminate between investment income and income from an active commercial or industrial business in a closely held Canadian corporation, the scheme under the 1972 Act is more sophisticated in achieving differentiated treatment of the two types of income. The principal ingredients of the tax on Canadian controlled private corporations<sup>18</sup> are fourfold: (1) all corporations pay the full corporate rate of tax on all their incomes;<sup>19</sup> (2) Canadian controlled private corporations may take advantage of the small business deduction<sup>20</sup> by taking as a credit against the tax otherwise payable an amount which is twenty-one percent of income from active business, within certain limits;<sup>21</sup> (3) a further tax incentive is available in the form of a deduction based on manufacturing and processing profits from an active business<sup>22</sup>; and (4) a refundable tax on investment income—which includes “income from a source that is a business other than an active business”<sup>23</sup>—is available to the corporation when it actually pays a dividend out of that income.<sup>24</sup>

The combined effect of these provisions is to permit qualifying small businesses to accumulate income from active business operations while encouraging distribution of profits from investments, thereby integrating corporate investment income into the individual shareholder's income in much the same way as occurred under the personal corporation provision. The major differences between the old and new approaches to providing a small business incentive and integrating corporate investment income with the shareholder's personal income are that the reduced rate of taxation is available only to qualifying private corporations, not to all corporations as in the 1952 Act, and the crude active-passive classification under the personal corporation provision has given way to a refinement which permits corporate income to be taxed at rates specially designed for each source of corporate income.

The small business deduction was not included in the reforms proposed

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<sup>17</sup> S.C. 1952, c. 148, ss. 38, 39, 67, 68 and 105, as amended.

<sup>18</sup> *Income Tax Act*, S.C. 1970-71-72, c. 63, ss. 125(6)(a), 89(1)(a).

<sup>19</sup> Section 123.

<sup>20</sup> Section 125(1).

<sup>21</sup> Section 125(1)(c) and (d), 125(2), 125(6)(b), as amended.

<sup>22</sup> Section 125.1.

<sup>23</sup> Section 129(4)(a)(iii).

<sup>24</sup> Section 129(1).



by the Carter Commission Report.<sup>25</sup> The Carter report offered a significantly different approach to taxation of small business,<sup>26</sup> an approach which involved total abolition of the preferential tax rate of twenty-one percent of corporate income under \$35,000 and an incentive in the form of accelerated depreciation on capital equipment for new and small unincorporated businesses. Incorporated small businesses were to be protected from the effect of the higher rates of corporate taxation by a new option to be taxed as a partnership.

This reform of the system of taxing small businesses was based on reasoning which was heavily criticized by proponents of small business.<sup>27</sup> The Commission Report argued that the preferential low rate of taxation on corporate income under \$35,000 combined with the dividend tax credit operated to levy an effective marginal rate of 38.78% on corporate income distributed to a shareholder in the fifty percent tax bracket—a concession which, it was argued, was particularly unfair because it was applicable to corporate income only, and did not extend to the incomes of unincorporated business.<sup>28</sup> The dual rate of corporate tax came under further criticism because there was no rational nexus between eligibility for the low rate and ability to form capital on the part of a particular type of corporation, because the low rate tended to cushion the market pressures on inefficient and declining firms, and because the concession had given rise to numerous loopholes which had to be countered with complicated provisions.

The Carter Report did acknowledge the need for an incentive for *new* businesses, distinguishing between the effect on the economy of new businesses and small businesses. New businesses, regardless of size, it was reasoned, promote competition and effectuate efficient allocation of resources, whereas *small* businesses represent a threat to the Canadian standard of living:

Although directly or indirectly subsidizing small businesses is sometimes justified on political or social grounds, maintaining an environment by countless numbers of small inefficient business units exacts a substantial cost in the long run in terms of a lower standard of living for Canadians.<sup>29</sup>

The Report rationalized that other reforms of the corporate tax system would solve the problem small businesses have traditionally experienced in obtaining financing and that any further concession to small business would be counterproductive. Thus it was proposed to aid small businesses, whether

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<sup>25</sup> The small business deduction which was eventually enacted as section 125(1) was originally proposed in the Standing Senate Committee on Banking, Trade and Commerce, *Report on the White Paper Proposals for Tax Reform Presented to the Senate of Canada* (Ottawa: The Queen's Printer, 1970) at 65, 79-82 [hereinafter *Senate Report*].

<sup>26</sup> See generally, Can. 4 *Report of the Royal Commission on Taxation (Carter Report)* (Ottawa: Queen's Printer, 1966) at 267-87.

<sup>27</sup> See, e.g., I. Asper, *The Benson Iceberg* (Toronto: Clark Owen & Co., 1970) at 221-30; Canadian Tax Foundation, *Annual Conference Papers* (Toronto: Canadian Tax Foundation, 1967) at 79-114; MacIntyre and Fields, *The White Paper: Black Looks from Small Corporations* (1970), 18 Can. Tax J. 131.

<sup>28</sup> 4 *Carter Report*, *supra* note 26, at 268.

<sup>29</sup> *Id.* at 272.

they be established or just commencing operations, by means of a rapid write-off of capital cost.<sup>30</sup>

The Carter Commission recommendations were incorporated into the White Paper on Tax Reform with few alterations, the most important proposals being the abolition of the two-tier corporate tax structure and the establishment of an election by a corporation to be taxed as a partnership.<sup>31</sup> However, popular reaction to the proposed treatment of small business influenced the Committee on Banking, Trade and Commerce<sup>32</sup> and the Committee on Finance, Trade and Economic Affairs<sup>33</sup> to reject the abolition of the low rate of tax.

While the Committee on Finance, Trade and Economic Affairs agreed with the Carter Commission and the White Paper that the *pro forma* low rate of corporate tax on the first \$35,000 of corporate income was "inequitable as between incorporated and unincorporated taxpayers,"<sup>34</sup> it took the position that "healthy small businesses are essential to the economic well-being of Canada."<sup>35</sup> The Committee was of the opinion that even if inequities as between incorporated and unincorporated businesses arose, some incentive must be given to *small* businesses with growth potential. However, the Committee refrained from commenting on the various incentive proposals which it had considered.

The Senate Committee on Banking, Trade and Commerce took a much more constructive position in its Report on the White Paper. As a consequence of its rejection of the integration scheme, the Senate Committee recommended that the low rate on the first \$35,000 of taxable income be retained but only for the "business income" of small business corporations.

These recommendations were based on policy considerations which had been rejected by the Carter Commission and the White Paper. First, the Senate Committee took the position that the low rate on the first \$35,000 of taxable corporate income was instituted "in order that the small corporation could generate funds for growth and expansion"<sup>36</sup> and that in the absence of an effective solution for financing problems of small business, the incentive should be retained. Second, the Senate Committee concluded that there was no purpose to be achieved in establishing equity as between incorporated and unincorporated taxpayers,<sup>37</sup> for unincorporated taxpayers—for example, employees and professionals—remain unincorporated precisely because there is

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<sup>30</sup> 4 *Carter Report*, *supra* note 26, at 276-82; 6 *Carter Report*, *supra* note 26, at 125-28.

<sup>31</sup> Minister of Finance, *Proposals for Tax Reform* (Ottawa: The Queen's Printer, 1969) at 4.30, 4.21 [hereinafter *White Paper*].

<sup>32</sup> *Senate Report*, *supra* note 25, at 63.

<sup>33</sup> Can. Standing Committee on Finance, Trade and Economic Affairs, House of Commons, *Eighteenth Report Respecting the White Paper on Tax Reform* (Ottawa: Queen's Printer, 1970) at 51-53 [hereinafter *Finance Report*].

<sup>34</sup> *Id.* at 51.

<sup>35</sup> *Id.* at 52.

<sup>36</sup> *Senate Report*, *supra* note 25, at 8.

<sup>37</sup> *Id.* at 81.

no benefit to be derived from incorporation.<sup>38</sup> The Committee was also of the opinion that the aggressive small business corporation does not compete with the nongrowth unincorporated business.

The Senate Committee, however, did agree that there were defects in the two-tier system and attempted to cure them with its recommendations. It suggested that the incentive be made available only to the *small* business corporation, since large corporations and the economy were "dependent upon growing small corporations". The Committee also recommended that taxable investment income of a corporation be excluded from the income in respect of which the incentive was to be calculated.<sup>39</sup>

### B. *Active Business and Controlled Foreign Corporations*

Many of the considerations which shaped the present scheme of taxation of domestic close corporations have received articulation in the FAPI rules<sup>40</sup> governing the taxation of closely-held foreign affiliates of Canadian taxpayers. Briefly summarized, these are: (1) noninterference with accumulation of surpluses in a corporation which has a *bona fide* business undertaking; (2) discouragement of abuse of the corporate entity as a means of sheltering investment income and income from other than a *bona fide* business undertaking from high rates of personal taxation; (3) grant of tax preferences to types of business undertakings which are seen as beneficial to the Canadian economy.

Before the 1972 revisions, the centre of attention was the corporation which was incorporated, financed and controlled in Canada, but which conducted its operations elsewhere and had no assets located in Canada. It is in

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<sup>38</sup> Strictly speaking, that is not true. The taxpayers in a number of cases have benefitted considerably despite the fact that they were employees. See, e.g., *Cameron v. MNR*, 72 D.T.C. 6325 (S.C.C.). Also, the benefits of incorporation and the resultant tax advantages are slowly becoming available to Canadian professionals: See H. Grascuk, *The Professional Corporation in Alberta* (1977), 25 Can. Tax J. 109, which discusses in detail the consequences of recent amendments to Alberta's *Companies Act* that enable professionals to incorporate.

<sup>39</sup> The specific terms of its recommendations were, in pertinent part:

[I]t is the considered opinion of this Committee that the following recommendations be made:

- (a) That the present two tier corporate tax system be retained.
- (b) That the two tier corporate tax system be for the benefit of the small business corporation only, and not for the large business corporation, the latter corporation paying the full rate on all its income.
- (c) That in respect of the small business corporation, the low rate would be applicable only to business income, and not to other business income, and not to other sources of income such as taxable investment income, which should be taxed at full corporate rates. The investment corporation should be excluded.

.....

- (i) That in defining business profits, reference be made to industrial and commercial profits, including farming and fishing operations.

<sup>40</sup> "FAPI" is an acronym for "foreign accrual property income, roughly translated as investment and non-arm's length service income." See section 95(2)(b) of the 1972 Act. Sections 91 through 95, and 126, together with Regulations sections 5901 through 5907, comprise the system which governs taxation of income that is derived from a source which is a nonresident corporation.

the legislation contrived to tax these corporations that the first attempts to discriminate between *bona fide* business undertakings and tax shelter operations may be found. Of particular importance in this regard are the words employed by the legislature to achieve the distinction now sought to be made with "active business." This discussion focuses on two phases: the period from 1917 through 1971, when Canadian claims on companies with foreign operations were fairly modest, and developments under the 1972 Act, when the net of the *Income Tax Act* was thrown more widely.

#### 1. The Years of Grace: 1917 to 1972

The *Income War Tax Act*<sup>41</sup> imposed an income tax of four percent on corporate income in excess of \$3,000 and all corporations "residing . . . or carrying on business in Canada" were subject to this impost. In 1918, an important exception to that broad jurisdiction was enacted:

4. The following income shall not be liable to taxation hereunder:—(k) the income of incorporated companies whose business and assets are carried on and situate entirely outside Canada.<sup>42</sup>

While it might seem obvious from our perspective that this provision was begging for abuse, refinements were slow to appear.

According to the plain language of the section, the Canadian corporate income tax could be avoided entirely by the simple expedient of (a) conducting all business operations outside Canada and (b) keeping all corporate assets outside Canada. Of course, it is practically impossible to uproot a thriving *bona fide* business undertaking and transplant it to another country without risking the loss of some customers, employees and vital connections—but this was not the manipulation which the exemption facilitated. Rather, it allowed taxpayers who had been required by the *Income War Tax Act* to pay Canadian tax on investment income to avoid taxation by the simple expedient of transferring the corporation which held those assets to another country and to let the income accumulate.

So long as the production of income from those assets looked like the conduct of business outside Canada, the requirements of section 4(k) were met and tax exemption was achieved until the income was repatriated as corporate dividends. Unfortunately, the definition of "business" in section 4(k) before the enactment of limiting amendments was never litigated.<sup>43</sup>

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<sup>41</sup> S.C. 1917, c. 28, s. 4(2).

<sup>42</sup> S.C. 1918, c. 25, s. 4, adding s. 5(k) to the *Income War Tax Act*. The section was renumbered as section 4(k) in R.S.C. 1927, c. 97.

<sup>43</sup> The only reported case under section 4(k) did not reach the point squarely. *Alberta Pacific Consolidated Oils v. MNR*, [1974] Ex. C.R. 48, 2 D.T.C. 886, turned on the finding that an unsuccessful attempt to find oil in Canada constituted a "business operation" and that royalties, leases and other rights connected with the exploration were "assets" such that their *situs* in Canada also operated to defeat the taxpayer's claim for an exemption. It was also noted that if necessary, it would be possible to hold that the lease of part of the taxpayer's business premises to another party amounted to a "business operation." However, that was *not* the basis for the decision and without taking full account of the purposes of the legislation, it would not follow automatically that such a broad view of "business operation" would be taken if the rental property were located on the other side of the border.

It is reported that the original version of section 4(k) was abused freely<sup>44</sup> and thus the slow process of qualifying its application to suit its purpose got underway. The first major limitation imposed on the section 4(k) exemption was an amendment in 1933<sup>45</sup> which precluded personal corporations from qualifying for the exemption. It will be recalled that it was not until 1940 that the "active business" requirement was grafted onto the personal corporation provision, so that tax liability under section 21 or exemption under section 4(k) depended entirely on whether more than twenty-five percent of the corporate income derived from enumerated forms of income-producing property. The 1936 amendments further limited the availability of the 4(k) exemption, restricting it to corporations which had "business operations" which were either "of an industrial, mining, commercial, public utility or public service nature" or "of an investment or financial nature."<sup>46</sup> Resident corporations with investment operations situated outside Canada were no longer able to avail themselves of the exemption. Reading these limitations together with the provisions enacted in 1933 which required resident corporations to pay a five percent withholding tax on dividends to nonresident shareholders, it can be seen that Canada was beginning to resile from the generous position first expressed in section 4(k).

The "either-or" mentality that received expression in the personal corporation provisions also prevailed in the taxation of foreign "industrial, mining, commercial, public utility and public service" corporations. So long as all of the requirements of section 4(k) (i) were met, such a corporation could repatriate its surpluses and accumulate income therefrom tax-free *in Canada*. The framers of the revised section 4(k) had little faith in the power of the term "business operations,"<sup>47</sup> for in addition to the requirement that the corporation *have* "business operations," the amendment required that they be of an "industrial, mining, commercial . . ." or "investment or financial" nature. This is the earliest attempt by a Canadian draftsman to give expression to the concept of a "*bona fide* business undertaking" in regulating tax treatment, and it may be viewed as the predecessor to the term "active business" in function if not in exact meaning.

The tax holiday came to an abrupt end in 1959 when the entire exemption was withdrawn; the time had come, it was suggested, for an examination of Canada's position in transnational trade and its tax policies in relation thereto.<sup>48</sup> The result of that conscientious and enlightened investigation was the reenactment in identical terms of the exemption later that year, with one modification: a corporation could qualify for the foreign business corporation exemption only if it had so qualified before the operation of the exemption

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<sup>44</sup> See I. Wahn, *Foreign Business Corporations* (1959), 13 Conf. Rep. 224 *passim*. This article gives a full and lucid legislative history of section 71 of the 1952 Act.

<sup>45</sup> S.C. 1933, c. 14, s. 2, amending s. 4(k).

<sup>46</sup> S.C. 1936, c. 38, s. 4, adding paras. (i) and (ii).

<sup>47</sup> *Clevite Development Co. v. MNR*, 61 D.T.C. 1093 *per* Thurlow J. (Ex. Ct.) has since demonstrated that their fears were groundless.

<sup>48</sup> See H. Crate, *Foreign Business Corporations* (1959), 13 Conf. Rep. 238; R. MacKay, *Foreign Business Corporations* (1959), 13 Conf. Rep. 242.

was suspended.<sup>49</sup> From 1959 until the enactment of the 1972 reform amendments, only pre-1959 foreign business corporations were exempt from corporate taxation; any resident corporations were liable for corporate income tax on their world income, just like any other "person" resident in Canada.

During the period from 1918 until the implementation of the FAPI rules, the jurisdiction over corporate foreign source income grew from an almost total abnegation of jurisdiction over income earned abroad to what might be thought of a "normal" jurisdiction, whereby corporate foreign income was brought into taxable income, subject to foreign tax credits and bilateral tax treaties. This "normal" jurisdiction, however, extended only to incomes of corporations formed in Canada or resident in Canada, and left one avenue open to Canadians who sought to shelter investment operations or accumulations. By the simple expedient of forming corporations in another country, and making certain that the corporation was not "resident" by the common law or statutory tests, Canadians could remove foreign source income from the reach of the fisc. By selecting the country of incorporation, investment or operation judiciously, income could be generated with little or no exposure to current tax liability, and because of the separate legal entities of the corporation and shareholder, corporate foreign source income tax was subject to Canadian income taxation only upon repatriation as dividends to shareholders. All this was changed by the FAPI rules.

## 2. The FAPI Provisions

"Foreign accrual property income" is identified in section 95(1)(b)(i) and (ii) as "incomes for the year from property and businesses other than active businesses" plus taxable capital gains reasonably allocable to 1976 or subsequent years. An extended definition of FAPI is set out in section 95(2), "determination of certain components of foreign accrual property income," but this section controls the classification of only two types of income—passive income which is incident to the conduct of active business and certain income from services.

The FAPI provisions were intended to discourage the use of tax havens to reduce or defer current Canadian tax liability for extraterritorial income-generating activities. These provisions follow the outlines of the U.S. *Internal Revenue Code* Subpart F provisions enacted in 1962, insofar as they seek to nullify tax avoidance effects of foreign business operations by imposing current tax liability on controlling shareholders with respect to undistributed income arising out of "passive" business as distinguished from "active" business of the corporation.<sup>50</sup>

While the Carter Commission was emphatic about closing off existing tax haven loopholes, little attention was devoted to the crucial distinction be-

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<sup>49</sup> The 1952 Act, s. 71(5), added by S.C. 1959, c. 45, s. 19.

<sup>50</sup> *Internal Revenue Code of 1954*, s. 954(c)(3). For a discussion of the mechanics of Subpart F, see J. Choate *et al.*, *Federal Tax Policy for Foreign Income and Foreign Taxpayers—History, Analysis and Prospects* (1971), 44 Temple L.Q. 441 at 466-71.

tween "active" and "passive" income; instead, the report addressed itself to the difference between income from business and income from property:

Property income is composed mainly of the normal forms of return from the investment of capital, the lending of money or the rental or licensing of property in another country, where the activity is not of such a character as to constitute the carrying on of a business. These forms of income (dividends, interest, rents and royalties) are usually subject, on distribution to a resident of another country, to "withholding" taxes levied by the source country.<sup>51</sup>

The Carter Commission was favorably impressed by the United States Subpart F provisions, which relied upon a distinction between active and passive income but which defined passive income in far greater detail than did the Commission or any of the other bodies responsible for the eventual enactment of the FAPI rules.

This lack of precision on the part of the Commission Report was embodied in the White Paper proposals respecting foreign source income, which erred in relying too heavily on reference to the United States Subpart F legislation to give full meaning to its proposal.<sup>52</sup> In contrast, the Committee on Finance found the Subpart F rules to be unnecessarily complex and broad in scope,<sup>53</sup> and the Committee on Banking rejected the passive income proposals of the White Paper as a "grave error." The Committee claimed that the American experience had proven Subpart F rules to be "inordinately complicated" and an "inefficient tool."<sup>54</sup> As a consequence of the debate over the appropriateness of the model, little useful discussion was devoted to the explicit results intended to be achieved by the implementation of such a system, or to the distinction to be drawn between active and passive income.

According to the terms of the provision that was finally enacted, FAPI can arise out of the operation of but one kind of business organization—the foreign affiliate.<sup>55</sup> A foreign affiliate can be either a nonresident corporation or a nonresident trust, a nonresident trust being deemed to be a foreign affiliate for purposes of these rules. The consequences of being categorized as a foreign affiliate are not unduly burdensome for shareholders of corporations resident in a country which has a tax treaty with Canada and whose income arises from the conduct of active business in a tax treaty country.<sup>56</sup> As long as such a corporation has no FAPI, dividends paid to shareholders resident in Canada will be considered to be paid out of exempt surplus if the resident

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<sup>51</sup> 4 *Carter Report*, *supra* note 26, at 497.

<sup>52</sup> The *White Paper* describes the foreign passive income proposals in paragraphs 6.20 and 6.21:

To counter tax-haven abuse, it is proposed to introduce United States-type legislation to deal with "passive" income. This is income of a foreign company which is not carrying on *bona fide* operations but to which income from other sources—dividends, interest, royalties and trans-shipment profits—is diverted. The U.S. law provides that in such circumstances the U.S. controlling shareholders are taxed on a current basis whether or not the income is distributed to them.

<sup>53</sup> *Finance Report*, *supra* note 25, at 88.

<sup>54</sup> *Id.* at 76.

<sup>55</sup> See section 95(1)(b), (1)(d), (4)(a) and (4)(b) for details of the classification.

<sup>56</sup> Regulations section 5907(1)(b)(iv).

taxpayer is a Canadian corporation, or will be included in gross income subject to normal gross-up and tax credit rules if the resident taxpayer is an individual. The most important component of exempt surplus is active business income.<sup>57</sup>

If the foreign affiliate derives income from an active business after 1975 in a country with which Canada does not or is not deemed to have a tax treaty, or has "income . . . from property or businesses other than active businesses," any dividends paid to its shareholder resident in Canada must be included as gross income in the year received by the taxpayer, although the dividends do carry with them an underlying foreign tax credit.

Thus the definition of "active business" is important to the tax planner who seeks to arrange business activities of the foreign affiliate to give rise to income from "active business" income which is therefore the source of tax exempt dividends. If income is foreign accrual property income, then the tax consequences depend on whether the entity is a controlled foreign affiliate of a Canadian resident.<sup>58</sup> Where a foreign affiliate amounts to a controlled foreign affiliate,<sup>59</sup> the distinction between income from active and passive business becomes crucial, for by operation of section 91(1), the taxpayer's *pro rata* share of the foreign accrual property income is included in his taxable income regardless of whether such income was distributed or distributable in that year.<sup>60</sup>

## II. POLICY CONSIDERATIONS RELATING TO THE ACTIVE BUSINESS PROVISIONS

The problems which arise in drafting legislation for domestic and extra-territorial corporations are in substance the same, differing only in degree. In both cases the issue is whether accumulation of profits in the corporation ought to be encouraged or deterred. Where the corporation operates extra-territorially, there is an added dimension to the fact of accumulation; Canada lacks ordinary jurisdiction to tax nonresidents on extraterritorial sources. However, this added dimension serves only to heighten the effects of the deferral which ordinarily results from the interposition of the corporate form.

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<sup>57</sup> Defined in Regulations section 5907(1)(d), "exempt surplus" consists of active business income net of local taxes for the post-1975 period, net incomes from 1972 through 1975 and certain capital gains.

<sup>58</sup> If an entity is not a *controlled* foreign affiliate, then FAPI is allocated to the affiliate's taxable surplus and dividends paid out of that account are taxable, with a credit for underlying foreign taxes, when received. See section 113(1)(b).

<sup>59</sup> A controlled foreign affiliate is a foreign affiliate as defined in section 95(1)(d) which meets the tests described in section 95(1)(a).

<sup>60</sup> For further information on the mechanics and objects of the foreign affiliate rules, see generally A. Scace, *The Income Tax Law of Canada* (3d ed. Toronto: Law Society of Upper Canada, 1976) at 670-750; see also R. Brown, *Foreign Affiliates—Surplus Accounts and Reorganization Provisions* (1975), 27 Conf. Rep. 859; R. Dart, *The Foreign Affiliate Regulations* (1976), 28 Conf. Rep. 104; J. Hausman, *The Tax Implications of Controlled Foreign Affiliates Under the FAPI Rules* (1975), 27 Conf. Rep. 850; J. Hausman, *Canada's New Tax Treaties* (1976), 28 Conf. Rep. 319; Steiss and Dart, *The Foreign Affiliate* (1976), 24 Can. Tax J. 241.



The policy question of what a domestic corporation should or may do with its surpluses is open to numerous resolutions because each element of the transaction is within the jurisdiction and subject to legislative fiat. Thus the issue of tax avoidance is a peripheral consideration in designing appropriate tax legislation. Where the corporation is nonresident, there is also a desire to manipulate taxpayer treatment of surpluses, but here tax avoidance by use of corporations which are outside the reach of the sovereign, is of central importance. With this rough characterization of the overall problem in mind, it is interesting to explore the policy considerations that led to the implementation of sections 125, 129 and 95 in the 1972 Act. This inquiry can be reduced to four steps: (1) what unique purpose did the legislature intend to achieve with the provision in question; (2) whether those objectives are properly conceived; (3) whether the formulation of the statute is consistent with those objectives; and (4) whether the provision is drafted in language that minimizes misinterpretation and misapplication by bureaucrats, taxpayers, administrative tribunals and courts.

Part I of this article set out the avowed purpose for which the section 125 "incentive" was introduced.<sup>61</sup> If the various politicians and interested observers are to be taken at face value, the small business deduction was designed to achieve the following purposes:

- (1) To enable small and new business to finance growth with retained earnings.
- (2) To lower entry barriers for small and new businesses in capital intensive industries.
- (3) To provide some means of compensating for the relative inefficiency of small firms, such inefficiency being one cause of large firm dominance.

The proponents of an effective lower rate of tax for small business corporations did not base their recommendations and predictions on empirical evidence which would tend to support their positions, nor did they found the desirability of such outcomes on econometric models or informed judgment. Lack of opposition to those unproven propositions may be due to the North American tradition of treating incorporated small businesses to a lower rate of tax.<sup>62</sup>

The unique purposes to be achieved by the implementation of the FAPI rules are much more believable and measurable—to curtail the use of non-resident corporations to shelter accumulations of income over which Canada has no jurisdiction, while at the same time retaining the tax benefits which flow from "normal" tax jurisdiction in respect of income from *bona fide* business operations.

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<sup>61</sup> Whether the small business tax credit is properly referred to as an incentive is open to debate. Depending on one's ideology, the preferred rate may be termed an indirect subsidy, a concession, booty or pillage. The term is not used here either as a term of art or as an indicator of the writer's personal opinion. For a condensed version of the debate over the rhetoric of tax policy, see B. Bittker, *Income Tax "Loopholes" and Political Rhetoric* (1973), 71 Mich. L. Rev. 1099.

<sup>62</sup> In the United States, all corporations are exempt from the surtax on taxable income on the first \$25,000 of taxable income, regardless of source: *Internal Revenue Code of 1954*, s. 11(d), limited by s. 1551. In Canada, the split rate was introduced in 1948.

### A. *Validity of the Purposes*

The issue of whether a particular policy objective is properly conceived is the chief difficulty in any analysis of tax legislation. It is clear that provisions such as section 125 can have unattainable objectives, and that even after a particular goal is reached it will have no impact on the economy. For example, even if it is assumed that the small business credit does accelerate reinvestment, lower entry barriers in capital intensive industries and offset small firm inefficiency, thereby redressing the dominance of large firms, there is no guarantee that the productive output of Canada will be affected.

As well, there is no evidence to support the assertion that those benefits will necessarily flow from *any* device designed to achieve such a purpose.

Because there is a shortage of research data upon which to base an evaluation of the legislative intent behind provisions such as section 125, and because economists and government financiers eschew even an estimate of the tax expenditure created by section 125, hardheaded criticism of the validity or propriety of its objects is impossible. This observation is made with a note of despair, for until tax legislation is scrutinized with the same skepticism accorded an expenditure budget, pointless preferential treatment with no observable effect on Canada as an economic unit will continue to be accepted either because it looks like a bright idea or because the magnitude of its impact is not appreciated.

In the absence of observable evidence that links legislative intent and economic phenomena, the scope of criticism of tax policy narrows radically. All that remains is to measure the proposed or existing legislation against various alternatives, in order to determine whether the best route to the objective has been taken (although lack of evidence again is a handicap), and to weigh the effects of the drafting against the initial objectives.

### B. *Alternate Methods of Assisting Small Business*

One useful way of assessing the device selected—in terms of type of legislation and the substantive conditions attached to its application—is to extract the operative conditions from the legislation and to examine their effect if a device other than a tax incentive of the nature proposed had been employed to achieve the same social or economic objectives.<sup>63</sup> Reading sections 125 and 129 together, the following preconditions to governmental assistance emerge:

- (1) The taxpayer must be incorporated in order to receive assistance.
- (2) The taxpayer must be Canadian controlled.

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<sup>63</sup> The analytic approach is set out in P. McDaniel and A. Raplinsky, *The Use of the Federal Income Tax System to Combat Air and Water Pollution: A Case Study in Tax Expenditures* (1971), 12 B.C. Ind. and Comm. L. Rev. 351. It is adapted to the case of the small business credit as well as possible in the absence of tax expenditures data. For want of data, the writer has drawn some very tentative conclusions as to the tax benefit to small business under section 125. These conclusions are based on Canada, Statistics Canada, *Corporations and Labor Unions Returns Act, Part I* (Catalogue 61-210, 1970, 1971, 1972, 1973, 1974) [hereinafter CALURA—Corporations].

- (3) The taxpayer may not have retained more than \$750,000 of net business profits since 1971 (referred to as the "cumulative deduction account").
- (4) The taxpayer may reduce the cumulative deduction account by paying dividends to shareholders.
- (5) The taxpayer is eligible for assistance of up to \$31,500 each year, depending on the level of net business income.

This is not a precise rendering of the terms and mechanism of the small business credit, but it is adequate to highlight the main features of the legislation: only corporations which have retained earnings of less than \$750,000 since 1971 are deemed to require assistance, and a maximum of \$31,500 may be awarded in each year of eligibility.<sup>64</sup> Eligibility, however, may be retained indefinitely by a regular pattern of distributions.

Because there is no limit on the total tax benefit which is available to each eligible taxpayer or to the class of eligible taxpayers as a whole under the terms of section 125, it becomes especially difficult to predict the magnitude of funding or concessions required to achieve the same result through alternative methods. It is possible to come up with a ballpark estimate of the annual cost of the credit, assuming that the cost is approximately twenty-five percent of the taxable business income of corporations which meet the general guidelines set out above. CALURA figures indicate that the magnitude of the tax credit could be somewhere in the \$100 million range in 1974, although this can be taken as a very rough figure at best.<sup>65</sup>

While it does not seem too invidious to leave an extra \$100 million in the hands of deserving small businessmen each year, the hidden effects of section 125 become clearer when its terms are recast in the form of legislation giving a direct subsidy to small business corporations. Such legislation would take the following form if it were to achieve the same effect as section 125:

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<sup>64</sup> These figures do not apply for each year since 1971; the 1972 credit was limited to 23% of \$50,000, and the amount has been increased gradually to its present level.

<sup>65</sup> According to CALURA—Corporations (1974), *supra* note 63, there were some 200,000 corporations in 1974. (Note that this figure is inconsistent with the figure of 258,501 corporations in 1973 reported in Canadian Tax Foundation, *The National Finances* (Toronto: Canadian Tax Foundation, 1977) at 73.) For the purposes of CALURA—Corporations, all corporations were separated into three categories: reporting foreign controlled, reporting Canadian controlled and unclassified. Reporting corporations have more than \$250,000 in assets or \$500,000 in sales. Twenty-five percent of all corporations are reporting corporations and they account for 95% of all taxable corporate profits. The unclassified corporations had average profits of \$5500 and average assets of \$70,000. 23% of the total profits of unclassified corporations—the amount of the small business credit—was \$175 million for 1974, \$148 million for 1973. CALURA—Corporations indicates at 19 that of the 138,500 unclassified corporations in 1974, some 3000 are foreign controlled, which would of course disqualify them from taking the small business credit. As well, not all corporations which fall into the unclassified category would necessarily qualify for the credit, nor are all reporting Canadian corporations necessarily disqualified from obtaining the credit.

Looking at the figures from another point of view, if all of the 135,000 Canadian controlled unclassified corporations had qualified for the maximum 1974 credit of \$12,500 per corporation, the revenue cost could have been as high as \$1552 million—almost ten times the amount that was likely to have been claimed. Greater accuracy will be possible with more detailed statistics. For the purpose of discussion, an actual credit of \$100 million in 1974 will be assumed.

The federal government will pay tax exempt subsidies to Canadian controlled corporations under the following circumstances:

- (1) The small business subsidy is available to corporations only.
- (2) The amount of the subsidy will vary according to the amount of the corporation's net taxable business income each year:

net business income	subsidy
\$150,000 or more	\$31,500
100,000	21,000
50,000	10,500
10,000	2,100
—nil—	—nil—
(loss)	—nil—

- (3) Corporations which reinvest business income in business assets will be disqualified from receiving the subsidy as soon as \$750,000 of business income earned since 1971 has been reinvested.
- (4) Corporations which reinvest business profits earned since 1971 to the extent of \$600,000 only and which then pass all subsequent profits on to shareholders as dividends or to officers as salaries will continue to be eligible for the full amount of the subsidy for an indefinite period of time.
- (5) Corporations which become highly levered by taking back distributions described in paragraph 3 as loans from shareholders remain eligible for continuing subsidies.
- (6) There are no requirements as to the use to which the corporation must put the subsidy, if any, although it is hoped it will be used to expand the business.

It is hardly doubtful that any legislator would submit such legislation for serious consideration, which causes one to wonder how section 125 ever found its way into the *Income Tax Act*.

It is difficult to recast section 125 into an investment tax credit or rapid amortization provision, simply because section 125 makes no direct reference to capital investment. The small business credit is available to a broad spectrum of corporations, including those which have virtually no depreciable capital, and accordingly any tax device intended to promote capital investment by corporations would benefit only some of the corporations which enjoy the rebate under section 125. The question presented by the alternative of investment stimulating devices is whether the economic purpose of a small business provision is better achieved through intensification of investment or by a generalized tax reduction as offered by section 125. The Carter Report originally proposed a rapid writeoff, and when that proposal was rejected, there was no substantive discussion of the differences between the two devices.

If the government were willing to forego the notional \$100 million of revenue represented by the small business credit, but were willing to do so only through an investment tax credit, then some interesting comparisons may be made. Assume that the government were willing to forego \$100 million in annual revenue or up to \$11,500 in revenue from each of 135,000 qualifying corporations, and that it wanted to increase the rate of capital investment from the 1973 figure of 6.5 percent for unclassified corporations to ten percent for 1974. If desired investment levels were reached, then the \$100 million would be consumed by a general ten percent credit, or by a thirty percent tax credit on any investment in excess of levels achieved the year before, up to a total expenditure by qualifying corporations of some \$340 million. That is, for its \$100 million investment credit, the government would receive an additional \$340 million in capital investment over the "normal" level.

Imposing the structure of section 125 on this enriched investment tax credit yields some strange results. A corporation with income of \$50,000 or more (using the 1973 version of the small business credit) would be able to take advantage of the full \$11,500 credit. But if such a corporation exceeded the expenditure required to generate the full \$11,500 credit, no further benefit would follow. Depending on whether the ten percent or thirty percent approach were selected, a corporation would be limited in terms of the total available credit not only by the amount of its total income, but also by previous investments. If a corporation has used up its total business limit by permitting the cumulative deduction account to mount up (which will happen with reinvestment), then no capital expenditure will give rise to an investment credit. At the other extreme, corporations which are in a loss or low income position will receive little or no recognition for capital expenditure as well. Only corporations near the top of the eligibility scale or those which borrow on distributions would qualify for the full benefit of the credit, again achieving inequitable results for aggressively growing corporations and corporations which are experiencing temporary losses.

Under any other scheme, the inequities would persist so long as the eligibility requirements of section 125 were continued.<sup>66</sup> Insofar as those requirements blatantly favor the nongrowth firm, or the corporation that indulges in thin capitalization, the small business credit or any similarly structured alternative fails to achieve the purposes it is said to have been designed to achieve. The problem, of course, lies in Parliament's conception of appropriate eligibility requirements. Whether the goal is increasing the after tax earnings of qualifying corporations generally, or stimulating all or some capital investment, the cumulative deduction account—total business limit device must be modified. Either the tax impact of leaving the credit behind should be mitigated, perhaps by a species of notch provision, or the salary/dividend bail out and thin capitalization response of some taxpayers ought to be regulated. An incentive to economic growth is buried in section 125, but it is offset by too powerful a disincentive in the same provision.

### C. *Administrative Feasibility*

It is unfortunate that in trying to establish a growth incentive for small business, Parliament ended up implementing a provision guaranteed to increase the number of tax-motivated incorporations and to petrify a segment of the corporate population in midgrowth. Moreover, the Act stated that the small business deduction was to be applied to the "active business income" of corporations, even though it is intuitively obvious to the most casual observer that "active business" is one of those elusive terms that is continually litigated and never elucidated.<sup>67</sup>

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<sup>66</sup> Devices such as guaranteed unsecured loans, low interest or interest free loans, if subject to the same eligibility criterion as section 125, would have the same "upside down" effect of direct subsidies or investment credits, as discussed. Modifications of the law regulating market structure, if designed to achieve the same effect as section 125, would be read as biased against small aggressive businesses.

<sup>67</sup> If the mass of litigation that arose under section 68 of the 1952 Act was not enough to convince the draftsman of the difficulties associated with the use of that term,

The "active business" distinction as used in both section 125 and section 95 is intended to winnow out a special class of business receipts for unique treatment. Under section 125 that unique treatment is a reduced rate of tax in some circumstances, under section 95 it is exemption from the deemed distributions provisions of the foreign affiliate rules. Although it would be convenient to equate "active business" with some generally understood concept such as "*bona fide* business undertaking" or "carrying on business,"<sup>68</sup> to do so would be to ignore the complex breakdown of sources which may be derived from a close reading of the respective sections. These breakdowns demonstrate that "active business" must mean something less than business in the ordinary sense if the integrity of the language employed in each scheme is to be retained:

*Incomes of a foreign affiliate:*

(1) *Investment income*

- (a) taxable capital gains
- (b) certain income from services
- (c) income from property that is not incident to the conduct of an active business
- (d) income from property that amounts to income from business other than an active business
- (e) income from business other than an active business that is not incident to the conduct of an active business

(2) *Business income*

- (a) income from property that is incident to the conduct of an active business
- (b) income from business other than active business that is incident to the conduct of an active business
- (c) income from property that amounts to income from business and income from active business
- (d) income from business that amounts to income from active business

*Incomes of a Canadian controlled private corporation:*

(1) *Investment income*

- (a) taxable capital gains
- (b) income from property other than a property held or used by the corporation "in the course of carrying on a business"
- (c) income from property that amounts to income from business but not income from an active business carried on in Canada
- (d) income from a business other than an active business carried on in Canada

(2) *Business income*

- (a) income from property used or held by the corporation "in the course of carrying on a business"
- (b) income from property that amounts to income from business and income from active business carried on in Canada
- (c) income from business that amounts to income from an active business carried on in Canada

Legislation which employs language for which there are no easy referents invites litigation and spawns that type of uncertainty which taxpayers abhor.

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heed could have been taken of the American experience. For a collection of the leading cases and articles, see R. Albrecht, *Application of the Active Business Requirement to the Tax-Free Spin-Off of Corporate Real Estate* (1976), 3 Pepperdine L. Rev. 221.

<sup>68</sup> This is not to suggest that "carrying on business" itself is not fraught with difficulty. See *Tara Exploration and Development Co. v. MNR*, 70 D.T.C. 6370 (Ex. Ct.), *aff'd on other grounds* 72 D.T.C. 6288 (S.C.C.); *cf. Birmount Holdings Ltd. v. MNR*, 77 D.T.C. 5031 (F.C.T.D.). In any event, that suggestion may be spurious in light of the fact that section 125(1)(a) refers to "active business *carried on* in Canada," whereas section 95 uses the unadorned expression "active business."

Part III of this article is devoted to an examination of the struggle to define active business in the context of section 125.

Some of the issues which have arisen in the attempt to define "active business" simply cannot be resolved by the interpretation of that term: whether all *types* of business operations should be eligible for the credit, whether property operations should be treated any differently than so-called commercial activities, and whether a corporation may maintain eligibility while actually conducting its operations through an independent contractor such as a management firm. Yet the courts ultimately have been forced to consider such questions when determining whether an undertaking constitutes an "active business" for purposes of section 125.

### III. THE EVOLVING CONCEPT OF ACTIVE BUSINESS

While a policy analysis of provisions which employ the "active business" device centres on the appropriateness of discriminating between different types of corporate business income, a legal analysis focuses on whether the language employed to communicate the rule communicates it accurately, and whether the rule is capable of being applied in an even-handed manner by administrators and judges. The analysis of these points should be treated as an interim report on the development of active business because only two cases<sup>69</sup> are appellate decisions, and one of the administrative rulings<sup>70</sup> is under appeal at present. The concept is not yet settled, although its outline is emerging.<sup>71</sup>

Given the pre-existing dichotomy between business and property as sources of income under the *Income Tax Act*, it is not surprising that confusion attends the demarcation of "active business." In the scheme for taxing both small businesses and controlled foreign affiliates, the terms "active business," "property" and "business" are used in a manner which requires separate meanings for each term.<sup>72</sup> Thus it would appear to be necessary to draw a distinction not only between active business and property, but also between active business and business. This three-way distinction being necessary, it then becomes necessary to identify the relationships between property, on the one hand, and business or active business on the other hand. The traditional approaches to statutory construction are of little assistance.<sup>73</sup> As interpretive

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<sup>69</sup> *MRT Investments Ltd. v. The Queen*, 76 D.T.C. 6158 per Jackett C.J. (F.C.A.) aff'g 75 D.T.C. 5224; *The Queen v. Cadboro Bay Holdings Ltd.*, 77 D.T.C. 5115 per Gibson J. (F.C.T.D.).

<sup>70</sup> *Marlee Investments Ltd. v. MNR*, 75 D.T.C. 153 (T.R.B.). Taxpayers recently discontinued appeals from two Tax Appeal Board rulings: *DSBK Management Ltd. v. MNR*, 75 D.T.C. 219 (T.A.B.) and *L&F Holdings Ltd. v. MNR*, 75 D.T.C. 150 (T.A.B.).

<sup>71</sup> For earlier discussions of the concept of active business, see *Qu'est-ce qu'une entreprise "exploitée activement"?* (1972), 2 Interlex 16-20; C. Boulanger, *La notion d'exploitation active d'une entreprise de l'alinéa 125(1)(a) de la loi canadienne de l'impôt sur le revenu* (1972), 3 Revue Generale de Droit 7-56; G. Covert, *Update of Basic Tax Concepts—Carrying on an Active Business in Canada* (1976), 28 Conf. Rep. 572; D. Sherbaniuk, *Current Corporate Tax Problems—Active Business Income* (1972), 24 Conf. Rep. 82.

<sup>72</sup> See text, *supra* at 55.

<sup>73</sup> See, e.g., *MRT Investments Ltd. v. MNR*, 75 D.T.C. 5224 at 5231-34 per Walsh J. (F.C.T.D.).

tools, they are too broadly stated, and simply did not develop in order to discriminate between different types and forms of businesses. However, an understanding of the underlying rationale for sections 125, 129 and 95 does suggest two approaches to determining the scope of active business. The first approach might be termed a functional theory of active business, the second a policy approach. A third approach, a variety of the literal approach, has also emerged.

The functional theory looks not just to the operation of section 125 (or 95) as controlling the definition of active business, but also takes account of its interaction with section 129. The combined effect of these two sections is to integrate personal and corporate taxation of "Canadian investment incomes"<sup>74</sup> while providing an incentive to incorporated businesses in the form of a reduced rate of tax on income from *bona fide* business undertakings. The function of the phrases "income from property," "income from business other than an active business" and "income from active business" must be seen as setting up the basic distinction between business and investment income which is required by the two sections. Income from property, and business other than an active business is treated as investment income by section 129; if a receipt does not fall into one of those two categories, then the scheme set up for Canadian controlled private corporations mandates that it be classed as income from active business—there is no third alternative.

When a functional approach is used, one would expect that the distinction drawn between business other than an active business or property, on the one hand, and active business, on the other hand, would approximate closely the distinction drawn between business and investment income in general tax law. With some modifications, this trend is evident in decisions under section 125.

A policy approach to defining active business also has some utility, especially when used in conjunction with the functional theory. It is no secret that when sections 125 and 129 were proposed, the scheme was to have been complemented by a tax on "ineligible investments"<sup>75</sup> which would negate the section 125 benefit insofar as it was applied to the purchase of investment property which did not generate income from active business. From the original proposal it can be deduced that "active business" was intended to have been construed narrowly; with the repeal of the limiting legislation, it can be argued that the original parliamentary intent continued unabated. This approach has been rejected, but something of the belief that not all types of businesses should qualify for the tax credit lingers on, for it is frequently argued that certain service operations, for example, or adventures in the nature of trade, should be excluded from the concept of active business, as Parliament did not intend to provide them with an "incentive." The obvious flaw in this reasoning is that such sources would then have to be treated as investments, and it is difficult to contemplate services or adventures as a

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<sup>74</sup> Defined in section 129(4)(a).

<sup>75</sup> See *MRT Investments Ltd. v. MNR*, 75 D.T.C. 5224 at 5232-33. The term is defined in section 189(4)(b) of the 1972 Act, now repealed, and included enumerated forms of investment as well as any property not used to produce income from an active business.



species of investment, especially when tax legislation was deliberately amended to bring the latter into business income.<sup>76</sup>

A third approach which can be and has been invoked in defining "active business" is more traditional than the first two. A straightforward application of the literal approach, the "activities test" merely seeks to imbue the modifier "active" with some meaning independent of "business," and does so by measuring the level of activity required to produce the income in question. This approach, like the others, is considered only when the income in question arises from a property operation, the type of business that has generated the most litigation under section 125 and raises the most doubt under section 95 as well.

Before grappling with the acceptance of any of these approaches in the decided cases, it is necessary to look briefly at two problems which arise in making distinctions between investment and business income. The first is whether the effect of incorporation will operate to establish any presumption that corporate receipts are income from an *active* business as well as income from business in the ordinary sense. The second is whether the legal relation between the "operating party"<sup>77</sup> and the corporation will have any influence on the classification of income from business, regardless of whether the "business" is an ordinary business operation or a property operation which is treated as a business.

This section will deal with these issues from the perspective of the decided cases on point, all of which arose in connection with the small business deduction. Further authority is provided by decisions under the former personal corporation provision, although they are relied upon only to augment the decisional law relating to the present active business provisions. It is possible to go even further afield and take note of the myriad American cases dealing with active business in corporate tax law as well, but it is believed that this undertaking would be only marginally productive in light of the array of statutory provisions in which the phrase is used.<sup>78</sup> Once one accedes to the proposition that legislative purpose and intended effect are valuable aids in the construction of technically complex statutes, it becomes difficult to justify the demand that a particular word or phrase have static meaning despite varying context. Even legislation aimed generally at abuse of the holding company concept—such as sections 95 and 125, in part—does not *a priori* dictate a uniform construction of "active business" as used in such provisions, for the simple reason that what might be impermissible and abusive taxpayer behavior in relation to the purpose sought to be achieved by one provision might be perfectly acceptable in light of the objects of another provision.

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<sup>76</sup> See the definition of "business" in section 248(1).

<sup>77</sup> This concept is borrowed from the regime governing the taxation of natural resources in the United States and Canada. "Operating party" refers to the party which is clearly conducting a business of carrying out certain kinds of operations; "nonoperating interest" represents a mere investment interest.

<sup>78</sup> See, e.g., *Internal Revenue Code of 1954*, sections 346, 355, 542(c), 542(d), 543(a), 921 and 954(c), all of which employ the active business technique in discriminating sources of income, and all of which have generated considerable litigation over the term.

### A. *The Effect of Incorporation*

In a very recent decision, Mr. Justice Cattanach observed that "the incorporation of a company merely raises a presumption of an intention to carry on business as outlined in the memorandum but this presumption may be rebutted and accordingly is not conclusive."<sup>79</sup> This rebuttable presumption is a familiar feature of income tax jurisprudence.<sup>80</sup> Although it has its roots in a questionable analogy,<sup>81</sup> it is routinely invoked where a corporation—frequently a holding company—earns income from "property" in the narrow sense in which that term is used in sections 3 and 9.<sup>82</sup> Reliance on the fact of incorporation as a reason for finding that a corporation is carrying on a business is often found where there is no particularly compelling substantive reason to find that the undertaking in question is a business, but where no grave injustice would flow from such a result. The presumption that a corporation carries on business can compensate for otherwise weak evidence.

Because the doctrine of incorporation has such vague application, it is especially troublesome to gauge the nature of the evidence required to rebut

<sup>79</sup> *Hillsdale Shopping Centre Ltd. v. MNR*, 77 D.T.C. 5256 at 5257 per Cattanach J. (F.C.T.D.).

<sup>80</sup> See J. Hannan and A. Farnsworth, *The Principles of Income Taxation* (London: Stevens & Son, 1952) at 155.

<sup>81</sup> Lord Sterndale gave life to the presumption with this justification in *IRC v. Korean Syndicate Ltd.*, [1921] 3 K.B. 258 at 273 (C.A.):

I do not think it would have been at all clear, if the Syndicate were an individual, that he was not carrying on a business; and for this reason. You would have to see what he was doing and why he was doing it, and if he was doing it, and if he was doing it under the circumstances in which the Syndicate was doing it—namely, trying to attain the object of acquiring a concession and turning the same to account—then, I think he might very well be carrying on a business. I do not admit either, that there can be no difference for this purpose once you get the individual and the company spending money on the same basis, then there would be no difference between them at all. But the fact that the limited company comes into existence in a different way from that in which an individual comes into existence is a matter to be considered. An individual comes into existence for many purposes, or perhaps for none, whereas a limited company comes into existence for some particular purpose, and if it comes into existence for the particular purpose of carrying out a transaction by obtaining concessions and turning them to account, then that is a matter to be considered when you come to decide whether doing that is carrying on a business or not.

See also *Anderson Logging Co. v. The King*, 52 D.T.C. 1209, *aff'd* 52 D.T.C. 1215 (P.C.); *Sutton Lumber and Trading Co. v. MNR*, 53 D.T.C. 1158 (S.C.C.); *Western Leaseholds Ltd. v. MNR*, 59 D.T.C. 1316 (S.C.C.); *cf. Irrigation Industries Ltd. v. MNR*, 62 D.T.C. 1131 (S.C.C.); *Canada Permanent Mortgage Corp. v. MNR*, 71 D.T.C. 5409 (F.C.T.D.).

<sup>82</sup> Even though "property" is defined very broadly in section 248(1), it cannot have the same broad meaning when used in the source formula "income from business or property" because all property which could also be classed as "business" would be taken out of the set "property." To put the proposition another way, income from property excludes income from business even though the concept of property includes business in other contexts in the Act. As the hallmarks of business are personal exertion, expertise and risk, it can be appreciated that the notion of income from property subsumes only income-producing property (a) that is not a business and (b) does not require the personal exertions of the owner to generate the income. See, e.g., *Hollinger v. MNR*, 73 D.T.C. 5003 (F.C.T.D.), 74 D.T.C. 6604 (F.C.A.), for a suggestion of this description of income from property.

the presumption. Where the corporation in question is a personal holding company, the issue becomes especially difficult because of the nature of such cases. Although taxpayer fraud is the exception in such instances, there are evidentiary problems in the ordinary case which arise from the corporation or shareholder's natural impulse to paint as favourable a picture as possible. At some point, however, the presumption is rebutted and then the determination of whether income is from business or property proceeds according to a determination of the substance of the operation. Many of the substantive tests employed are those applied to individual taxpayers who earn income from property in the course of what is alleged to be business.

The implications of the doctrine of incorporation to the problem of defining active business are obvious. If a corporation can be said to be carrying on business simply because it is incorporated, then it is plausible to class as "other than active business" those property operations which are nudged into the "business" category chiefly because they are conducted by a corporation, reserving classification as "active business" for operations which are not property operations. If this reading of sections 95, 125 and 129 is accepted, then the schemes governing domestic and nonresident close corporations were formulated in light of an expectation that the effect of incorporation would operate to class all receipts as business income.

If it is not accepted that sections 95, 125 and 129 were structured with the effect of incorporation in mind, then it is more difficult to identify the referents for the terms "other than active business" and "active business" without doing violence to the language. If "other than active business" is not meant to create an irrebutable presumption that property operations are investment operations in the hands of a corporation, then business in the ordinary sense has been subdivided into "other than active business" and "active business" on some other basis, perhaps the level of "activity" surrounding the production of profits. If that is the case, then the inherent redundancy of "active business" is troublesome.<sup>83</sup>

The effect of incorporation has received minimal direct attention in the section 125(1) cases, but a great deal can be gleaned from inference. The conclusion one must reach is that the effect of incorporation is firmly established in judicial thought processes, sections 125 and 95 memorialize the doctrine with the trifurcation of sources into "property," "other than active business" and "active business," and alleged holding companies will be treated no differently than any other corporation. For example, in *MRT Investments Ltd. v. The Queen*,<sup>84</sup> Mr. Justice Walsh expressly considered the fact that the taxpayer was a corporation in classifying its sources of income taking the point of view that if a public or private corporation carries on the business for which it is formed it creates a presumption that the profit from these activities is a profit derived from the business. Even when the effect of incorporation is

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<sup>83</sup> Without the doctrine of the effect of incorporation, there would be no need to divide corporate income-earning operations into "business" and "active business." The ordinary business category is required to catch property operations, which are not "real" or "active" business according to the draftsman.

<sup>84</sup> 75 D.T.C. 5224 (F.C.T.D.).

coupled with the "time, attention and labor" test of business, it is still an influential factor and necessitates the use of some other test for "active business." Walsh J.'s analysis was not criticized in *The Queen v. Rockmore Investments Ltd.*,<sup>85</sup> although Chief Justice Jaccett did not advert to the effect of incorporation, but restricted his reasoning to differentiating property, business and active business as sources.

In a more recent judicial opinion, Mr. Justice Gibson considered the effect of incorporation in *The Queen v. Cadboro Bay Holdings Ltd.*:

[I]ncome from "a business other than an active business" must mean income from a business that is in an "absolute state of suspension"; . . . devoid of any quantum of business activity, but which has some asset which produces income.<sup>86</sup>

This statement reflects a belief that incorporation transforms all corporate receipts into business receipts. Unless the Supreme Court negatives the effect of incorporation for small business corporations, the tripartite classification of sources under section 125(1) will continue to present conceptual difficulties.

A modification of the property-business-active business approach employed by Chief Justice Jaccett in *Rockmore Investments* is developed in *Cadboro Bay Holdings*. Mr. Justice Gibson agreed that "active" is not intended to operate to exclude dormant businesses because the section speaks of *incomes* and not sources; a dormant corporation would not have any incomes. He also agreed that "active" operates "to exclude some business having sufficient activity in the year to give rise to income." He then concluded that there must exist some "quantum of activity" which qualifies an undertaking as an active business.<sup>87</sup> However, in the interest of "the smooth working of the system," he held that business is virtually synonymous with active business:

[A]ny quantum of business activity that gives rise to income in a taxation year for a private corporation in Canada is sufficient to make mandatory the characterization of such income as income from an "active business carried on in Canada."<sup>88</sup>

He also stated that "business" means any activity which falls within the extended definition of business in section 248(1) or within its ordinary meaning, but that it excludes investments. By recognizing that a corporation can have investment income, Mr. Justice Gibson denies the full impact of the effect of incorporation, and leads the way in reducing it to a less significant role in the classification of corporate sources of income.

#### B. Who May "Act" for the Corporation

Corporations may derive income from a source that is an active business directly or indirectly, as owners, joint venturers or partners, under agreements containing a vast array of provisions. The issue which arises under sections 125, 129 and 95 is whether the degree and quality of the corporation's interest in the source, the active business, has any effect on classification of the income in the corporation's hands. The predominant forms of interest in an active

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<sup>85</sup> 76 D.T.C. 6156 (F.C.A.).

<sup>86</sup> 77 D.T.C. 5115 at 5122 *per* Gibson J. (F.C.T.D.).

<sup>87</sup> 77 D.T.C. at 5123.

<sup>88</sup> *Id.*

business that a corporation would ordinarily hold include the following: (1) ownership of all interests, managed by employees, officers or independent contractors; (2) ownership of all interests except a bare operating economic interest held by a management firm, for example; (3) an interest in a partnership, joint venture or syndicate that conducts an active business; (4) an economic interest only, either operating or nonoperating; (5) an interest in a trust or (6) shares in another corporation which has an active business.

Scant attention has been paid to these issues.<sup>80</sup> This is unfortunate, because choice of the wrong "actor" can turn active business into "passive business" when proper planning would ensure the desired tax result. The contrary is true as well for those who would prefer to receive the section 129 refundable dividend taxes rather than take advantage of the small business credit. Because only a few of the section 125(1) cases have touched on the relational aspects of income from an active business,<sup>90</sup> recourse must be had to some of the common law principles relating to business in the ordinary sense. If Gibson J.'s suggestion that business and active business are synonyms is accepted, there should be no objection to transferring those principles to this statutory context.

### 1. Ownership and Operating Control

Where the owner of a business operates it through persons over whom it has the legal right and potentiality to control—even if it is never exercised—then the general rule is that the "activity" of the actors, be they servants or independent contractors, will be imputed to the owner of the business. This proposition flows directly from common law principles.<sup>91</sup> However, in dealing with the effect of independent management on an active business, the courts have stumbled around a little in reaching a position on the effect of independent management.

The decision-makers went astray in the first cases, in *Centennial Shopping Ltd. v. MNR*<sup>92</sup> and *ESG Holdings Ltd. v. MNR*,<sup>93</sup> in which the interposition of a management firm was held to preclude characterization of the income as deriving from an active business. Mr. Prociuk's reason for denying the credit in *Centennial* was simply that the management firm was not subject to the taxpayer's direction from day to day. The error in *ESG Holdings* was compounded when Mr. Justice Walsh of the Federal Court concluded that if it were not for the fact that the corporation's business was actually conducted by an

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<sup>80</sup> See N. Dickson, *Income—Does the Source Flow Through* (1977), CCH Provincial Inheritance & Gift Tax Reports, paragraph 20,033; H. Kellough, *The Business of Defining a Partnership Under the Income Tax Act* (1974), 22 Can. Tax J. 190 at 206-08.

<sup>90</sup> *ESG Holdings Ltd. v. MNR*, 75 D.T.C. 5224 per Walsh J. (F.C.T.D.) rev'd 76 D.T.C. 6158 per Jaccett C.J. (F.C.A.); *DSBK Management Ltd. v. MNR*, 75 D.T.C. 219 (T.R.B.); *Centennial Shopping Centre Ltd. v. MNR*, 74 D.T.C. 1190 (T.R.B.).

<sup>91</sup> See H. Plaxton, *Canadian Income Tax Law* (2d ed. Toronto: Carswell, 1947) at 214-15, n. 9, 1. See also *Shorrt v. MNR*, 60 D.T.C. 1056 per Thurlow J. (Ex. Ct.); *No. 439 v. MNR*, 57 D.T.C. 401 (T.A.B.); *Parisien v. MNR*, 51 D.T.C. 349 (T.A.B.).

<sup>92</sup> 74 D.T.C. 1190 (T.R.B.).

<sup>93</sup> 75 D.T.C. 5224 per Walsh J. (F.C.T.D.) rev'd 76 D.T.C. 6158 per Jaccett C.J. (F.C.A.).

independent contractor who received a fixed fee, the corporation would be entitled to compute its tax liability under section 125(1).

The misunderstanding was corrected by Chief Justice Jackett, who held that ESG Holdings was in no way disqualified by its use of a management firm.<sup>94</sup>

With respect, I do not agree that there is any material difference in principle, in so far as the carrying on of an active business by a corporation is concerned, between carrying it on through the agency of officers or servants of the corporation and carrying it on through the agency of an independent contractor.<sup>95</sup>

The Chief Justice does not give any reasons for his conclusions, but it is apparent that there are several influential factors which support it. First, it may be said that the mere retention of an independent contractor is strong evidence that the operation with which he is charged is a business or an active business.<sup>96</sup> Second, use of an independent management firm is an acceptable commercial practice, limited only by the directors' duty to retain control over policy matters,<sup>97</sup> and differs in principle from the employment of servants only by degree. Third, so long as the directors fulfill their legal duty to manage the corporation, the "direction and control" concept would be irrelevant in determining whether employees and independent contractors should be treated differently.<sup>98</sup>

Where a management arrangement is a sham, or the directors have abrogated their statutory duties by contract or impermissibly fettered their discretion, the treatment of the agency relation becomes inextricably bound up with the purposes and perceived limits of the active business formula. In such cases, the factual evidence may well tend to establish that the corporation itself is not operating a business even to the extent implied by supervision by an active board. It is questionable, however, that the subjective test—the

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<sup>94</sup> 76 D.T.C. at 6159.

<sup>95</sup> Cf. *Tsuda Canada Ltd. v. MNR*, 76 D.T.C. 1010 (T.R.B.), in which it was held that use of an independent contractor for processing lumber rendered the corporation ineligible for manufacturing and processing incentives because the relevant statutory provision stipulated that the operations be carried on "by it". The narrow reading given "by it" is justifiable; where there are no words of limitation, however, an independent contractor is as good as the taxpayer.

<sup>96</sup> The difficulty with this position is that the attributes of the relationship might render the owner of the property in question a mere investor if the owner has no skill, knowledge, expertise or involvement in the operation.

<sup>97</sup> Corporate legislation envisions limited delegation of authority by the directors to other parties. See, e.g., *Canada Business Corporations Act*, S.C. 1974-75, c. 33, ss. 110, 117; *The Business Corporations Act*, R.S.O. 1970, c. 53 as amended, ss. 132, 133, 144, in which the directors are charged with a duty to "manage" or "supervise" the business of the corporation.

<sup>98</sup> As long as the directors retain control over matters of policy, a management contract *per se* should not represent an abrogation of that duty. But see *Kennerson v. Burbank Amusement Co.*, 120 Cal. App. 2d 157, 260 P. 2d 823 (1953); *Cullen v. Governor Clinton Co.*, 279 App. Div. 483, 110 N.Y. 2d 614 (1952), reproduced in Iacobucci, Beck, Grover and Johnson, *Cases and Materials on Corporations* (2d ed. Downsvew: Osgoode Hall, 1976) at 6-30 ff., which suggest limits on the extent which the directors may fetter their discretion by means of a management contract. See also cases collected in W. Cary, *Cases and Materials on Corporations* (4th unabridged ed. Mineola: Foundation Press, 1979) at 221 ff.

identity of the actors and their relation to the corporation—would override the ascendant objective test, which looks to whether the operation itself is a qualifying business. For the purpose of sections 125 and 129, the courts may take the position that any relation that does not fall afoul of the associated corporations rules or the deeming rules will support the application of those provisions. To the extent that the more usual relation will be some form of agency, such an approach would be consistent with the purpose of the legislation; however, a few unusual issues will present difficulty.

## 2. Ownership and an Economic Interest

There is substantial authority to support the proposition that mere ownership of property which is used in the conduct of someone else's business, coupled with an interest in the production or profits from that business, does not give rise to business income or active business income. Indirect authority may be found in *MNR v. Spooner*<sup>99</sup> and many of the cases arising under section 12(1)(g). Direct authority is to be found in sharecropping cases,<sup>100</sup> in which owners of farmland who leased their land in exchange for a portion of the annual crop attempted to establish that they were carrying on business as a consequence of the relation. In all but one case,<sup>101</sup> the contention was rejected.

In *Peery Estate Inc. v. MNR*<sup>102</sup> and *Westphalen v. MNR*,<sup>103</sup> Canadian farmland was owned by nonresidents and operated by tenants who surrendered a share of the produce as rent. The reasoning employed by Mr. Fisher in *Peery Estate Inc.* is reproduced in *Westphalen*, and centered on three aspects of the facts: (1) the nature of the relationship between the taxpayer and the occupier of the premises, (2) the nature of the taxpayer's risk in the operation and (3) the form of payment for use of the land. The form of the legal relation of landlord and tenant was treated as dispositive in characterizing the receipts as rentals in *Peery Estate Inc.* However, Mr. Fisher did indicate that had counsel made submissions regarding the effect of the form of the payment, he would have considered that factor as well, and he did not believe that classification of the receipts as rentals followed inexorably from identification of a landlord and tenant relation.

Mr. Fordham did not display the same precision in *Westphalen v. MNR*, where he held that the relation between the owner and farmer was that of landlord and tenant and therefore that the receipts were rentals or income from property. This decision reached the proper result but fell into the error of relying on the formal relationship to classify the receipts instead of considering it as one bit of evidence which would not necessarily be conclusive by itself.<sup>104</sup>

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<sup>99</sup> 1 D.T.C. 211 (S.C.C.), *aff'd* 1 D.T.C. 258 (P.C.).

<sup>100</sup> *Peery Estate Inc. v. MNR*, 52 D.T.C. 202 (T.A.B.); *Westphalen v. MNR*, 64 D.T.C. 194 (T.A.B.); *Holvik v. MNR*, 54 D.T.C. 115 (T.A.B.).

<sup>101</sup> *No. 404 v. MNR*, 57 D.T.C. 117 (T.A.B.).

<sup>102</sup> 52 D.T.C. 202 *per* Fisher (T.A.B.).

<sup>103</sup> 64 D.T.C. 194 (T.A.B.).

<sup>104</sup> *Cf. In re Mulligan*, 45 F. Supp. 763 at 766 (Neb. D.C. 1942), in which a standard form farm lease which was embellished with clauses providing that the owner of the farm was employing the lessee to operate the farm, in return for 50% of the produce, was held to constitute a mere lease and not an employment contract. This reasoning

In all of these cases the board members came ever closer to stating that the form of the relationship controls classification of receipts as income from property, business or active business, ignoring risk, control and form of payment. The result thereby achieved is correct but the reasoning is incorrect. The better view is that in such an arrangement, where the only formalized relations concern use of property and division of profits therefrom, the lessor really holds the estate in the land plus a nonoperating economic interest—a share of the profits. Consistent with the treatment of other items which conveniently fall into the class of nonoperating economic interest, these receipts are income from property and not from business or active business.

Where a particular relationship involves an economic interest as well as an independent contractor, it is difficult to predict whether the income of the non-operating party will be treated as income from business or investment property. If the substance of the agreement is a management contract, then the rule enunciated in *ESG Holdings* would probably prevail, but if the agreement conferred a large economic interest on the other party in return for consideration other than or in addition to management services, a court should be able to characterize the receipts as income from property by section 12(1)(g) or common law.<sup>105</sup>

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was reflected in *No. 404 v. MNR*, 57 D.T.C. 117 (T.A.B.). *No. 404* is not a decision one instinctively trusts, for Mr. Fisher went to the trouble of ruling inadmissible evidence of a lease agreement between the taxpayer and the "employee" who operated the farm in exchange for 50% of the crop. With the lease contract out of the way, Mr. Fisher held that the substance of the relationship was a joint venture because the taxpayer continually advised the "employee" on various matters. See also *Hoivik v. MNR*, 54 D.T.C. 113 *per Fisher* (T.A.B.).

<sup>105</sup> Where the taxpayer is incorporated, the point is not without difficulty, due to the effect of incorporation and the chimerical concept of a "source," *CIR v. Korean Syndicate Ltd.*, [1921] 3 K.B. 258 (C.A.) held that an eight percent mining royalty was income from business, notwithstanding that the corporate activity consisted of nothing more than compliance with statutory formalities, receipt of royalties and payment of dividends. The relation between the operating and non-operating parties resembled a lease relation more than a management arrangement.

On substantially similar facts, *Hollinger North Shore Exploration Co. v. MNR*, 60 D.T.C. 1077 *per* Thurlow J. (Ex. Ct.) *aff'd* [1963] S.C.R. 131, 63 D.T.C. 1031 *per* Abbott J. held that \$3 million in mining royalties received in consideration for the sublease of mining property was exempt from taxation as "income derived from the operation of a mine" under section 83(5) of the 1952 Act. The Minister had contended that the "source" of the income was either the sublease or the property right conferred on the sublessee, and thus the source was not the operation of the mine. Mr. Justice Thurlow held that the "practical man" would view the operation of the mine as the source of income, and Mr. Justice Abbott agreed, subject to the slight modification that the relation was in substance a joint venture. Although the issue of the classification of the source as business or property did not arise, implicit in the characterization of the source is the view that the income did not arise from a nonoperating economic interest (essentially the Minister's argument) and thus was not income from property. By describing the relation as a joint venture, Mr. Justice Abbott would have been able to treat the receipts as income from business, and presumably an active business.

The difficulty presented by these two decisions is that on the one hand, such royalties will be treated as "passive" income, but business income nonetheless, and on the other, as income from business, and probably active business as well. One resolution of the conflict thus created would be to let the form of the relation govern: if a "lease" as in *Korean Syndicate*, it is passive income; if from a "lease" as in the *Hollinger North Shore Exploration* joint venture, it might be income from an active business.



### 3. Partnership, Trust, Corporations, etc.

*Hollinger v. MNR*<sup>106</sup> established that the conduct of an active business through a partnership does not alter the character of the income regardless of whether the partner is silent or actively engaged in the conduct of the business. Whether this proposition can be extended to limited partners is difficult to predict, although the economic interest in such a case would dominate the relation.<sup>107</sup> On the other hand, where the "investment" is risky, the return on the investment will be determined by persons over whom the taxpayer has no control, and such a relation certainly is viewed as a variety of partnership, the existence of which is contingent on the existence of a business in the ordinary sense.<sup>108</sup> Although *Hollinger* concerned an individual taxpayer, there is no reason to expect a different result for corporate partners.<sup>109</sup>

Mr. Justice Noël's reasoning is of general application to the distinction between business and property income. Counsel for the taxpayer submitted a fourfold test by which business and property income could be distinguished:

- (1) whether the income was the result of efforts made or time and labour devoted by the taxpayer;
- (2) whether there was a trading character to the income;
- (3) whether the income can be described as income from a business within the meaning of that term as used in the Act and, finally
- (4) the nature and extent of services rendered or activities performed.

Mr. Justice Noël properly rejected the first and last criteria because they were "subjective," dealing not with the objective attributes of the activity, but rather with "the person receiving the income." He is clear on two points: the ultimate "source" of income was business, and classification of receipts as income from property is a function *not* of the nature of the relationship between the owner and the income-producing property, but of the true nature of the income-producing operation. He utterly rejects the possibility that using an intermediary other than an agent or independent contractor could transform the source of that income from business into property.<sup>110</sup>

<sup>106</sup> 73 D.T.C. 5003 *per* Noël A.C.J. (F.C.T.D.) *aff'd* without written reasons 74 D.T.C. 6604 *per* Jaccett C.J. (F.C.A.).

<sup>107</sup> See, e.g., *The Limited Partnerships Act*, R.S.O. 1970, c. 247, as amended by S.O. 1973, c. 6, ss. 4, 13(2), 16, in which a limited partner is restricted from participating in control of the business, and may "advise" as to management only. *Cf. Mr. W. v. MNR*, 52 D.T.C. 1150 (Ex. Ct.).

<sup>108</sup> See H. Kellough, *The Business of Defining a Partnership under the Income Tax Act* (1974), 22 Can. Tax J. 190 at 196-99.

<sup>109</sup> *Canada Business Corporations Act*, S.C. 1974-75, c. 33, s. 15(1); *The Business Corporations Act*, R.S.O. 1970, c. 53, as amended, s. 15(2)(4).

<sup>110</sup> Mr. Justice Noël states in 73 D.T.C. at 5008-09 the converse of the proposition which is being argued in this section, i.e., that the interposition of an entity of any character will fail to disturb the nomination of business as a source:

If income from property has any meaning at all, it can only mean the production of revenue from the use of such property which produces income without the active and business-like intervention of its owner or someone on his behalf. I have in mind, for instance, property such as bonds or debentures or real property which do not require the exertion of much activity or energy in order to produce the revenue.

Presumably this reasoning would apply where the taxpayer held a business through the intermediary of an estate or trust as well. See, e.g., *Trans-Canada Investment Corp. v. MNR*, 53 D.T.C. 1227, *aff'd* 55 D.T.C. 1191 at 1193 *per* Rand J. *dissenting* (S.C.C.).

The effect of the interposition of a trust, of course, would be the same as for a partnership, for "ownership" through a trust implies an interest in the *res*, the active business, and not in the trust itself. However, the terms of the trust could affect the role of the trustees and the rights of the beneficiaries in the individual properties of the trust to such an extent that the beneficiaries would hold little more than a mere economic interest. It might be expedient for a corporation to operate a business through the intermediary of a trust, and some care should be taken to remain eligible for the small business credit.

### C. The Activities Test

None of the three approaches to defining active business mentioned earlier in this section have received complete acceptance. Nor has any one approach become immutably associated with a particular form of income.

Where corporate income derives from the rental of real property, reasoning tends to vacillate between the activity test and the functional approach, with Gibson J. as the sole proponent of the latter approach.<sup>111</sup> The activities test developed slowly in successive opinions of the Tax Review Board, the suggestions having originated in *Centennial Shopping Centre Ltd. v. MNR*.<sup>112</sup> Mr. Prociuk expressed no doubt that the operation of a small shopping centre was an active business, but reserved the right to ignore the "activity" in the face of certain evidence.<sup>113</sup> *Farlan Investments Ltd. v. MNR*<sup>114</sup> gave further support to the activities test when it rejected the notion that a rental operation could be classified as a business operation automatically, without any measure of the level of activity required to produce the income.

*Smithers Plaza Ltd. v. MNR* enunciated the activities test cogently, placing emphasis on the "question of degree" while warning that "activity" may not always be what it seems:

In many instances, of course, the difference between income from an investment and income from a business is not clear-cut. Activities connected with the investment of capital and the collection of revenue therefrom are often merged with those activities which could qualify as business operations.<sup>115</sup>

To complicate matters further, Mr. Cardin also introduced overtones of the functional test into his analysis of the income from a small shopping centre.<sup>116</sup> He noted that if business in the ordinary sense is described as "an income-generating organization" in which "capital, labour and management are coordinated and manifestly operative," then that description of business, "though

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<sup>111</sup> *The Queen v. Cadboro Bay Holdings Ltd.*, 77 D.T.C. 5115 (F.C.T.D.).

<sup>112</sup> 74 D.T.C. 1190 (T.R.B.).

<sup>113</sup> Mr. Prociuk ruled that the corporation was not engaged in the conduct of an active business *itself*, and therefore did not have income from an active business. Of course, this reasoning has been invalidated by *ESG Holdings Ltd. v. MNR*, 75 D.T.C. 5224 *per* Walsh J. (F.C.T.D.) *rev'd* 76 D.T.C. 6158 *per* Jaccett C.J. (F.C.A.), and it is doubtful that the small difference (a flat fee plus a percentage fee) would be a sufficient basis upon which to distinguish the cases.

<sup>114</sup> 75 D.T.C. 12 (T.R.B.).

<sup>115</sup> 75 D.T.C. 137 at 138 (T.R.B.).

<sup>116</sup> The corporation did not retain a management firm to operate the premises, but did employ a janitor to maintain the common areas.

certainly not all-embracing, might . . . serve as a guideline in the interpretation and application of section 125(1) of the Act.”<sup>117</sup>

A recent administrative decision, *Spence Building Ltd. v. MNR*,<sup>118</sup> reverts to the unaided degree of activity test in analysing the income derived from renting a building to a partnership of medical practitioners for their clinic.<sup>119</sup> The evidence indicated that the lessee was obligated by the lease to take full responsibility for maintaining the property; the lessor was responsible for municipal taxes, insurance and structural repairs only. Mr. Taylor concluded on these novel facts that the degree of activity on the part of the corporation was inadequate to constitute the conduct of an active business, although it was equally clear that the undertaking was a business. Using the *Spence* decision as a model of the activity test, a difficult question must be resolved before the test is acceptable as a principle of tax jurisprudence. If a quantum of activity is required to promote a source from business to active business, what is that quantum, or is it to be measured by intuition, superstition, or commonsense?

*The Queen v. Cadboro Bay Holdings Ltd.*<sup>120</sup> can be read as resolving these points. The taxpayer corporation owned and operated a small shopping centre, and operations were carried out by employees and agents of the corporation. Mr. Justice Gibson set out a number of propositions which he believes constitute a compromise between the “quantum of activity” approach and the functional approach. His first proposition, unsupported by any direct authority, is that in order for income to qualify for section 125 treatment, the “business activity” of the corporation must be of “sufficient quantum” to be categorized as “income from ‘an active business . . .’”<sup>121</sup> In Gibson J.’s view, this proposition translated into a two-part test of active business, determining whether (a) the corporation had a business as defined in the *Income Tax Act* and (b) that business was an active business. He justified this quantum of activity approach by construing “active” as bearing its vernacular meaning as used in leading cases in which the concept of business was in issue.<sup>122</sup>

Gibson J.’s second proposition is that cases construing other statutory provisions are applicable in principle only and that the provisions of sections 125 and 129 must be construed according to the purpose of the legislation. Relying on *The Queen v. Rockmore Investments Ltd.*,<sup>123</sup> Gibson J. stated that “active” does not exclude dormant businesses only, for section 125 deals with the incomes of corporations, and thus “it must be assumed that the word ‘active’ was used to exclude some businesses having sufficient activity in the year to give

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<sup>117</sup> 75 D.T.C. 137 at 138.

<sup>118</sup> 77 D.T.C. 71 (T.R.B.).

<sup>119</sup> Some of the partners were also shareholders of the corporation which leased the premises, but this fact did not seem to have been given much weight.

<sup>120</sup> 77 D.T.C. 5115 (F.C.T.D.).

<sup>121</sup> 77 D.T.C. at 5123.

<sup>122</sup> As can be appreciated readily, the cases upon which Gibson J. supposedly relied do not lead inexorably to his conclusion: See 77 D.T.C. at 5120-22.

<sup>123</sup> 76 D.T.C. 6156.

rise to income.”<sup>124</sup> On the other hand, he asserts that “a business other than an active business” refers to “income from a business that is in an ‘absolute state of suspension’ and is devoid of any quantum of business activity, but which has some asset which produces income.”<sup>125</sup>

Locked into the necessity to define “business activity” or watch his theory crumble, Gibson J. invokes the canon of construction which permits a court to choose a rendering of an ambiguous term which will be “consistent with the smooth working of the system” and presents a meaning of active business which eliminates confusion.<sup>126</sup>

[A]ny quantum of business activity that gives rise to income in a taxation year for a private corporation in Canada is sufficient to make mandatory the characterization of such income as income from an “active business carried on in Canada”<sup>127</sup>

Thus the formulation “active business” calls for “business activity” before a corporation qualifies to compute its tax liability under section 125. But the concept of “business activity” is perhaps as elusive as the quantum of activity required to constitute active business.

#### D. *The Functional Approach*

It can be appreciated that Gibson J. merely substituted “business activity” for “active” in the formulation “active business” in *Cadboro Bay Holdings Ltd.* As his subsequent discussion reveals, “business activity” is virtually synonymous with “business” as defined in section 248(1).

Gibson J. swept away the myth that active business is any different from business even while affirming that the two concepts are distinguishable. The reasoning is convoluted, but there is no easy way to explain why two seemingly discrete terms should operate similarly and have such similar definitions, unless one accepts that the function of the phrase “active business” is to reserve the small business tax credit for income from a *bona fide* business undertaking, as distinguished from investment income. It is noteworthy that Gibson J.’s formula applies not only to rental income, but also to interest, royalties, management fees and other marginalia. His Lordship sums up with a conviction previously missing from section 125 decisions. The most important statements are reproduced here:

- (1) *Any business within the meaning of section 248(1) of the Income Tax Act or within the dictionary definition of business is a business.*

<sup>124</sup> 77 D.T.C. 5115 at 5123.

<sup>125</sup> Gibson J.’s unfortunate choice of terms creates an inconsistency; if he is to be taken at face value, then “income from other than an active business” includes (1) income from an income-producing asset held by a corporation which is in an absolute state of suspension as well as (2) income of a corporation which has sufficient activity to give rise to income but which does not derive from an active business.

<sup>126</sup> Gibson J.’s reasoning can be criticized here because the difficulty in defining “active business” is that it is a redundant term of broad and indeterminant reference; it is, however, “ambiguous” in the sense that it has more than one usual and plausible meaning.

<sup>127</sup> 77 D.T.C. at 5123.

- (2) Any business activity at all, of a private corporation in Canada, irrespective of the quantum of it, is sufficient to make mandatory the characterization of the income from such source for tax purposes income from an "active business" within the meaning of section 125 of the Act.
- (3) There may be many types or sources of income from an active business within the meaning of section 125 of the Act. Such types or sources of income may be or from rents, interest, royalties, management fees and so forth. The relevant matter is whether from the particular type or source, income arose which should be categorized as income from an "active business carried on in Canada" by a private corporation within the meaning of section 125 of the Act.
- (4) Investment income of a private corporation is certain income within the meaning of section 129 of the Act. Such investment income is any income from a source other than from "an active business carried on in Canada" within the meaning of section 125 of the Act or from an "office" or "employment", (see sections 3(1) and 248(1) of the Act) and includes income from "property". (See section 3(1) of the Act.)<sup>128</sup>

So long as *Cadboro Bay Holdings* is a leading authority on the interpretation of "active business," eligibility for the small business credit requires only that the taxpayer have some "business activity." "Business activity" (when considered without regard to quantum) will have to be defined as business in its general sense. That is, factual evidence as to the quantum or degree of activity will not be crucial to the categorization of income, but evidence that an activity, no matter how miniscule, is a "business" activity instead of an office, employment or property activity, is determinative. The tripartite distinction between property, business and active business income has now reverted to the old two way distinction between business and nonbusiness income.

Despite the note of finality in the *Cadboro Bay* opinion, one issue remains unresolved, and this is whether income generated from an adventure in the nature of trade constitutes income from active business. Mr. Justice Gibson is quite clear in his conclusion that if income derives from a source that is business, then it derives from active business, and the fact that certain undertakings are deemed business instead of business in the ordinary sense should not make any difference. But there are three variations on "income from business" which raises semantic difficulties if not substantive issues as well: "carrying on business,"<sup>129</sup> "in the course of [carrying on] business,"<sup>130</sup> and "active business." The semantic quirks arise when "adventure" is substituted for "business" in these formulations. In *Tara Exploration and Development Co. v. MNR*,<sup>131</sup> President Jackett said that he thought that "carrying on an adventure" was a grammatical absurdity; is it also an absurdity to speak of "in the course of [carrying on] an adventure" or an "active adventure"?

Section 139(1)<sup>132</sup> clearly stipulates that "[i]n *this Act*" (my emphasis) business is to include an adventure in the nature of trade, but despite that

<sup>128</sup> 77 D.T.C. at 5123.

<sup>129</sup> Section 2(3).

<sup>130</sup> Section 18(1)(h).

<sup>131</sup> 70 D.T.C. 6370 per Jackett P. (Ex. Ct.) *aff'd* 72 D.T.C. 6288 per Abbott J. (S.C.C.).

<sup>132</sup> *Income Tax Act*, S.C. 1952, c. 148, now s. 248(1) in *Income Tax Act*, S.C. 1970-71-72, c. 63.

direction, *Tara Exploration* has tentatively held that it is impossible for an adventure to amount to "carrying on business" and two court decisions have held that under section 68 an adventure did not constitute "active business."<sup>133</sup> No doubt it would be arguable on the basis of these decisions to say that an adventure does not fulfill any of the statutory requirements that refer to "in the course of business" either, but the point has never arisen.

Implicit in President Jackett's analysis in *Tara Exploration* is the assumption that "carrying on business" refers to ordinary business only. Not only does he point to the semantic impossibility of "carrying on an adventure" but he also states that an isolated transaction, even if "deemed" business, does not display the requisite elements of "*carrying on business*" such as continuity and repetition.<sup>134</sup> In short, he reads the words "carrying on" as modifying "business" and sets up a requirement that some repetition of transactions must be displayed in the conduct of the undertaking.

One recent case, however, has attempted to deal with this proposition, although the decision cannot be taken as having settled the issue. *Birmount Holdings Ltd. v. MNR*<sup>135</sup> arose on facts similar to those in *Tara Exploration*, with one vital difference. Tara was formed to undertake mining exploration, and the "adventure" was held to be unrelated to the ordinary business of the corporation. That is why "adventure" had to be invoked in order to bring it into income in the first place. Birmount Holdings, however, was formed to hold one parcel of undeveloped land, and its objects were limited to that single purpose. Thus it would have been difficult to hold that the transaction fell outside the scope of the ordinary business of the corporation, because either the corporation *had* no ordinary business, or the ordinary business consisted of holding the land.

The threshold question in *Birmount Holdings* was whether the sale of the land generated business profits of any kind, or whether the corporation should be treated as an investment vehicle, generating investment income only. The effect of incorporation does not operate to classify all receipts of a corporation as business receipts,<sup>136</sup> and certainly it is open to a court to conclude that the operations of a holding company are investments. Accordingly, Sweet D.J. held that the transaction was taxable as an adventure in the nature of trade.<sup>137</sup>

Possibly because it was an isolated transaction, he did not go further and decide whether the transaction constituted business in the ordinary sense. However, he did deal with that precise issue in a slightly different manner,

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<sup>133</sup> *Stekl v. MNR*, 59 D.T.C. 1262 per Thorson P. (Ex. Ct.); *Hillsdale Shopping Centre Ltd. v. MNR*, 77 D.T.C. 5256 per Cattanaach J. (F.C.T.D.).

<sup>134</sup> 70 D.T.C. at 6376.

<sup>135</sup> 77 D.T.C. 5031 per Sweet D.J. (F.C.T.D.).

<sup>136</sup> *Hillsdale Shopping Centre Ltd. v. MNR*, 77 D.T.C. 5256 at 5257 per Cattanaach J. (F.C.T.D.):

At the very most the incorporation of a company merely raises a presumption of an intention to carry on business as outlined in the Memorandum but this presumption may be rebutted and accordingly is not conclusive.

<sup>137</sup> 77 D.T.C. at 5039.

when he considered whether the corporation was resident because it was "carrying on business." Against the backdrop of the President Jackett's reasoning in *Tara Exploration*, "carrying on business" carries the connotation of business in the ordinary sense. Here the relationship between the objects of the corporation and the subject matter of the transaction was determinative, for Sweet D.J. held that the transaction was not only an adventure, but that the corporation "carried on business in and with the land."<sup>138</sup>

Although *Tara Exploration* and *Birmount Holdings* can be and were distinguished on a factual matter, the troublesome question remains: where a corporation engages in an isolated transaction, can it ever be described as carrying on business? President Jackett's reasoning is preferable inasmuch as he bases his conclusion on a close reading of the words of the statute. Sweet D.J., on the other hand, seems to believe that the effect of incorporation is an adequate evidentiary substitute for the element of continuity and repetition so crucial to a finding of business in the ordinary sense.

The active business decisions under section 68(1) display the same reluctance to read "business" as modified by "active" as including an adventure or isolated transaction, notwithstanding the extended definition of "business" in what was then section 139(1)(e). The first two decisions were fairly anomalous, because the Minister was trying to establish that an adventure *did* amount to an active business. In *Baker Estates v. MNR*,<sup>139</sup> the taxpayer won because the transaction did not even constitute an adventure, being consistent with the corporation's investment purposes. In *No. 418 v. MNR*<sup>140</sup> however, Mr. Fordham rejected the Minister's proposition in an *obiter dictum*, preferring to base his conclusion on the finding that the corporation did not have an active business because it was "dormant," with no office, records or compliance with formalities. Alternatively, he held that the corporation was merely acting as the controlling shareholder's agent in the collection of oil royalties and trading gains in oil permits, and had no business of its own.

Mr. Fordham's *dictum* was adopted *sub silentio* by President Thorson in *Stekl v. MNR*,<sup>141</sup> in which the shareholder-taxpayer was assessed on gains realized by his personal corporation in the disposition of timber limits. The appeal was brought on the ground that the transaction was on capital account, but in holding that the taxpayer had been properly assessed, President Thorson had to have concluded that the transaction did not constitute the conduct of an active business.<sup>142</sup>

In the context of section 68(1), adventure may have been denied classification as "active commercial, industrial or financial business" not because

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<sup>138</sup> The integrity of President Jackett's analysis in *Tara* can be retained if one views the decision in *Birmount Holdings* as resting on the concept of business in the ordinary sense and not mere adventure in the nature of trade.

<sup>139</sup> 54 D.T.C. 514 at 516 (T.A.B.) [official translation].

<sup>140</sup> 57 D.T.C. 243 (T.A.B.).

<sup>141</sup> 58 D.T.C. 494 (T.A.B.), *aff'd* 59 D.T.C. 1262 (Ex. Ct.).

<sup>142</sup> The same analysis was imposed in *Berman v. MNR*, 75 D.T.C. 49 (T.R.B.) and *Hillsdale Shopping Centre Ltd. v. MNR*, 77 D.T.C. 5256 (F.C.T.D.).

it was not "active," but because it was not "commercial, industrial or financial" business. The better view of "carrying on business" and "active business" is that both phrases employ "business" in its widest statutory and jurisprudential meaning, which includes an adventure. Although the constructs "carrying on an adventure" or "active adventure" are ludicrous and ungrammatical, to constrict the definition of "business" to its ordinary sense whenever it is used in a grammatical unit with an inelegant verb is inconsistent with the statutory definition of business. Thus when a corporation seeks to classify income from an adventure as income from an active business, there should be no objection by the Department: business activity and business intention are present. "Business" when modified by "active" has no special or restricted meaning, and thus the profits would be income from an active business.

#### E. Policy as an Aid to Construction

*MRT Investments Ltd. v. The Queen*,<sup>143</sup> although affirmed by the Federal Court of Appeal on slightly different grounds, illustrates the third possible approach to describing active business—the "purpose" approach. Words in a taxation statute should be given their ordinary meaning consistent with the context in which they are used and the purpose of the provision.<sup>144</sup> Because of legislative waffling during the infancy of the 1972 Act, however, two arguments as to the "purpose" of the active business provision can be made. First, the enactment of the rules concerning ineligible investments<sup>145</sup> can be interpreted as limiting the scope of operation of section 125, even though the ineligible investments provisions were repealed as of their effective date. The second view is that the repeal of the limiting provision must be interpreted as signifying Parliament's intention to extend the small business credit to any operation which fell within the literal meaning of an active business. The latter argument was accepted by Mr. Justice Walsh in *MRT Investment Ltd.*, opening the way to giving "active business" its full literal meaning without regard to the type of business.

Walsh J. held that the taxpayer corporations' diminutive money lending operations constituted active businesses because there was nothing in the statutory provision that excluded investment companies from that classification.<sup>146</sup> On a factual analysis, active business is broadly defined in the *MRT* decisions. The income for 1972 against which the plaintiffs sought to take the small business deduction was \$12,200 in mortgage interest by ESG, and a total of \$4,600 in interest, rental and service income for Rockmore. The

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<sup>143</sup> 75 D.T.C. 5224 per Walsh J. (F.C.T.D.) *aff'd*, 76 D.T.C. 6158 per Jaccett C.J. (F.C.A.).

<sup>144</sup> E. Driedger, *The Construction of Statutes* (Toronto: Butterworths, 1974) at 81-84, quoted in *MRT Investments Ltd. v. The Queen*, 75 D.T.C. 5224 (F.C.T.D.).

<sup>145</sup> Sections 188, 189 of the 1972 Act, repealed by S.C. 1973-74, c. 14, s. 60, applicable to 1972 and subsequent years. Part V provided for a refundable tax on ineligible investments, and "ineligible investments" were defined by section 189(4)(b) as "property that was not acquired for the purpose of gaining or producing income from an active business . . . except money . . . [and] obligations . . . ."

<sup>146</sup> 75 D.T.C. at 5234.



three corporations were operated out of a common office, although only ESG paid for management, rent, telephone and bookkeeping. Under section 68(1), the only investment operation that was granted the status of active business was a mortgage investment operation in *Graham v. MRT*,<sup>147</sup> in which the appellant taxpayer had over \$250,000 invested in a mortgage business to which he devoted full-time managerial efforts. In *MRT Investments*, however, the amount invested was much less, and the management was merely part time.

The liberalization of the concept "active business" displayed in *MRT Investments* was foreshadowed by earlier board rulings on moneylending. Judge Flanigan set the tone in *Cosmopolitan Investments Co. v. MNR*<sup>148</sup> when he held that a mortgage investment company which had only \$9,500 invested in mortgages at the end of the tax year had an active business.<sup>149</sup> Subsequent rulings varied the general rule only slightly. *Lazare Investments Corp. v. MNR*<sup>150</sup> and *Parico Ltée v. MNR*<sup>151</sup> follow the new tradition of granting the small business credit to small, almost ephemeral mortgage investment companies that would not have been classed as active businesses under the 1952 Act.

However, the line between investment and active business is a fine one, as demonstrated by two other rulings which placed emphasis on the subjective relationship between the corporation and the borrowers. In *L. & F. Holdings Ltd. v. MNR*<sup>152</sup> mortgage loans to friends of the corporation's controlling shareholder were not business activities; in *Marlee Investments Ltd. v. MNR*,<sup>153</sup> income from a note, six mortgages and a small building was not income from active business because the corporation, managed by the controlling shareholder through his law office, appeared to be no more than an alter ego of the shareholder. The decision did not discuss that point, but focused on the degree of activity and incidents of corporate existence.

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<sup>147</sup> 70 D.T.C. 1747 (T.A.B.); cf. *Glaspie v. MNR*, 63 D.T.C. 828 (T.A.B.); *McCorkell v. MNR*, 61 D.T.C. 154 (T.A.B.).

<sup>148</sup> 74 D.T.C. 1252 (T.R.B.).

<sup>149</sup> *Contra*, *L. & F. Holdings Ltd. v. MNR*, 75 D.T.C. 150 (T.R.B.); *Marlee Investments Ltd. v. MNR*, 75 D.T.C. 153 (T.R.B.); Mr. St-Onge's refusal to allow the taxpayer in *L. & F. Holdings* to take the small business deduction is attributable to the fact that the \$274,000 invested in some 16 mortgages was borrowed largely from family members and loaned to family friends, none of whom were deemed to deal at arm's length—although the clients certainly seemed to be obligated for the rate of interest usual to this type of transaction. In *Marlee Investments*, he merely held that the taxpayer, which had some 6 mortgages outstanding, producing \$17,000 in payments, was "not very active". Of course, *L. & F. Holdings* and *Marlee Investments* could be viewed as setting the proper standard if *Cosmopolitan* is seen as an anomaly—the result being explained by the fact that the appellant corporation was once upon a time a thriving and extensive money lending operation which had experienced reversals but retained the *potential* for significant financial activity.

<sup>150</sup> 75 D.T.C. 26 (T.R.B.).

<sup>151</sup> 75 D.T.C. 173 (T.R.B.).

<sup>152</sup> 75 D.T.C. 150 (T.R.B.)—the taxpayer's appeal was allowed on a consent judgment in January 1977.

<sup>153</sup> 75 D.T.C. 153 (T.R.B.), (now under appeal).

## F. *The Antiavoidance Construction*

The theme of self dealing is ubiquitous, and to the extent that it can arise in relation to almost any type of business operation, it is significant in ascertaining eligibility for the small business tax credit. The question arises in the context of three common types of incorporated undertakings: management operations, professional practices and incorporated hobbies. The main issue in each case is not whether the corporation has a business in the ordinary sense—for it is submitted that the substance of the operations will easily constitute a business—but whether the small business credit should be denied on other grounds.

### 1. Management Operations

Management operations have recently been the subject of litigation, and the decisions indicate that so long as the corporation has a *bona fide* business undertaking, the corporation will be treated as a separate legal entity, entitling it to the tax benefits of incorporation, if any.<sup>154</sup> Taking Mr. Justice Gibson's two part test of active business, it is apparent that if a management corporation survives the scrutiny given to alleged sham transactions, then it should also qualify for the small business credit as a corporation that carries on business and earns income through "business activities."

In the one case dealing with the eligibility of management operations for the small business credit, *DSBK Management Ltd. v. MNR*,<sup>155</sup> the taxpayer appears to have been disqualified from using the credit on the basis that it did not have a *bona fide* business undertaking. The shareholders of the corporation were accountants who were partners in an accounting firm, and their wives. Although the corporate charter disclosed that the purpose of the corporation was to provide management services to professionals "and others," the records of the company, disclosed that the management firm's only client was the accounting firm. Mr. Frost summed up this relationship by noting that "[a]side from performance of professional duties, the professionals were managing themselves, and there was little left to manage."<sup>156</sup>

Mr. Frost analysed three major factors in arriving at his conclusion: (1) the volume and frequency of transactions, (2) the quality and nature of management decisions that are required to generate income and (3) the use made of capital and labor. He also ascribed secondary importance to the fact of incorporation and the declared objects in the corporate charter. No men-

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<sup>154</sup> See generally D. Bonham, *Judicial Treatment of the Corporate Entity Concept in Canadian Tax Law* (1967), 6 Western Ont. L. Rev. 39; J. Hausman, *The 'One-Man Company'—Some Principles of Taxation* (1967), 13 McGill L.J. 265; D. Matheson, *Service Corporations* (1976), 24 Can. Tax J. 329; W. Mitchell, *Taxation and the Corporate Veil* (1966), 14 Can. Tax J. 534; G. Tamaki, *Lifting the Corporate Veil in Canadian Income Tax Law* (1962), 8 McGill L.J. 159.

<sup>155</sup> 75 D.T.C. 219 (T.R.B.). The taxpayers appeal to the Federal Court was discontinued upon a consent to judgment on June 9, 1977. However, the Tax Review Board's analysis continues to be instructive.

<sup>156</sup> 75 D.T.C. 220 at 221.

tion was made of the formalistic attributes of doing business, such as office space, staff, stationery, etc. The overriding consideration in evaluating the activity of a management company, however, was described as "what management is doing":

The function of management is to gain, and if possible to enhance, profits by bringing into harmonious relationship all the successful elements of a business. If management skills require deliberate action to enhance profits, the business so managed is, in my opinion, likely to be of an active nature. Management may be provided by virtue of special contract or through it *what management is doing*, not who does it.<sup>157</sup>

Mr. Frost found that management was inactive—the financial statements indicated "little activity," the management fee consisted of a flat five percent of the accounting firm's expenses and the use of capital and labor was "relatively insignificant" because no such expenses were reflected on the financial statements. This line of reasoning suggests that business in the ordinary sense and active business can be distinguished, for there is little question that unless there is some evidence of a tax avoidance motive for the incorporation, the operation would be treated as a business. One could conclude, then, that one management contract is insufficient to constitute an active business even if it is a business.<sup>158</sup>

A contradictory line of reasoning is introduced by Mr. Frost's assertion that "Parliament never contemplated the sort of activity carried on by the appellant company as qualifying for the said section."<sup>159</sup> Having admitted that the undertaking was an "activity" or "business activity," *DSBK Management Ltd.* emerges as the result of antiavoidance sentiment instead of dispassionate analysis. Unfortunately, not even the antiavoidance grounds are clearly articulated, and thus it would appear that another *bona fide* management operation could still be subject to attack either for non-arm's length contracts or for the size of its client list.<sup>160</sup>

One other avenue of attack on a management corporation is described in *Smith v. MNR*,<sup>161</sup> in which a management corporation was denied active business status when the evidence disclosed that its agent (a controlling shareholder of both the taxpayer and client corporations) was acting in his capacity as an officer of the client corporation and not as an agent of the taxpayer. In essence, this is a variation on the sham doctrine, but the reasoning is pertinent to the recent surge of interest in incorporating the administrative and

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<sup>157</sup> *Id.* at 220.

<sup>158</sup> *Cf.* Revenue Ruling 14.

<sup>159</sup> 75 D.T.C. 220 at 221.

<sup>160</sup> See also *ACR Corporate Services Ltd. v. MNR*, 76 D.T.C. 1323 (T.R.B.).

<sup>161</sup> 70 D.T.C. 6344 (Ex. Ct.). See also *Shulman v. MNR*, 61 D.T.C. 1213 (Ex. Ct.) in which Ritchie J. held that a solicitor who formed a corporation for the purpose of providing management services for the solicitor's law firm, through the agency of the solicitor himself, had merely established a conduit through which to withdraw money from the operating revenue of the law firm and return it as a loan. The judgment clearly indicates, however, that if an "unrelated" management firm had been employed, the management fees paid would have been a *bona fide* expense of the law firm.

management side of professional practices, especially where incorporation of the practice itself is barred. Characteristic of all such arrangements is a non-arm's length relation, and *DSBK Management* and *Smith* are by themselves inadequate to determine the extent to which the credit is available for such operations. However, it is submitted that an arm's length management corporation which manages a professional practice would be entitled to use the small business credit.

The crucial question in determining whether a corporation has a *bona fide* management business or is engaged in a non-arm's length transaction is largely a matter of degree and circumstance. The rigid objective view of such relations is slowly giving way to a more subjective view which assesses evidence as to the parties' past and proposed conduct. Thus the capacity and potential to attract and service arm's length clients, coupled with some evidence of intention to do so within a reasonable time, would be sufficient to establish a corporation as having a *bona fide* business.<sup>162</sup> Beyond that, it is safe to say that evidence of an arm's length client would establish that the corporation had "any business activity at all." Where there are no arm's length clients, but there is substantial business activity, the weight of authority would hold that there is no active business. Whether the basis for doing so would be a finding of self dealing or tax avoidance is impossible to predict at this time.

## 2. Professional Corporations

The incorporation of the professions is a contentious topic, and one of the more controversial aspects of the debate is whether a professional corporation is entitled to the small business credit.<sup>163</sup> Since there is absolutely no question that the practice of a professional constitutes business in the ordinary sense,<sup>164</sup> and as well, an active business, the issue reduces itself to determining whether section 125 applies to professional corporations, or whether for some arcane reason the statute must be construed as excluding professional corporations.

One perfectly sensible argument is that professional corporations do not have the kinds of businesses section 125 was designed to encourage, and that the small business credit cannot be claimed for such income. Proponents of this position could point out that professional corporations were not extant at the time of the enactment of section 125, and that the shortlived ineligible investments provision makes it clear that only corporations of the commercial, financial or industrial ilk were within Parliament's contemplation. These points, when coupled with commentary as to the purpose of the small business credit

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<sup>162</sup> See also D. Matheson, *Service Corporations* (1976), 24 Can. Tax J. 329.

<sup>163</sup> H. Grascuk, *The Professional Corporation in Alberta* (1977), 25 Can. Tax J. 109 at 113-14.

<sup>164</sup> *Davies v. Braithwaite* (1931), 18 T.C. 198 at 204; *Seni v. MNR*, 63 D.T.C. 694 (T.A.B.); *No. 361 v. MNR*, 56 D.T.C. 478 (T.A.B.). In *Seni v. MNR*, the issue was whether certain consulting fees, payments for teaching and other payments for services rendered by an engineer who was not yet licensed in Canada because of a citizenship requirement constituted income from business or employment. He was found to be engaged in a professional business.

and the history of its enactment, make a strong argument against permitting a corporation with a professional business or other atypical business undertaking to utilize the credit.

The weakness of this argument is obvious: there is nothing in the language of section 125 to support the proposition that certain types of active businesses are to be precluded from the meaning of active business. Again referring to Gibson J.'s two part proposition in *The Queen v. Cadboro Bay Holdings Ltd.*,<sup>165</sup> a professional corporation has a business, for section 248(1) expressly stipulates that "business" includes a profession, and practice of a profession would undoubtedly constitute "any business activity at all." With the exception of *DSBK Management Ltd. v. MNR*<sup>166</sup> and some of the earlier administrative rulings, the courts consistently have refused to recognize any limitations as to the type of operation to which the credit applies, in the absence of express language.

One final argument which might avail those who would deny the credit to professional corporations is that the corporation itself does not "have" the active business and that the permissive nature of a statute facilitating incorporation of a professional practice does not confer upon such a corporation the same status as a business corporation.<sup>167</sup> If the corporation is not carrying on the business through its organs and agents, then it may not take the credit in respect of income from that source. The sentiments of the participants in the debate are clear, but the legal theory upon which they are founded is not. The debate promises to continue for some time yet.

### 3. Incorporated Hobbies

Aside from hobby farming, the tax treatment of hobbies has not attracted much attention in Canada. One point that is likely to arise in future litigation, however, is the eligibility of incorporated hobbies for the small business credit. Since corporations are generally deemed to be carrying on business for all purposes, before the Department could launch an attempt to exclude hobby income from active business income it would have to establish that the income arose in the pursuit of the controlling shareholders' pleasure. There is enough case law in Canada to facilitate the distinction between hobby receipts and income from business, and thus the issue is whether such receipts, if classified as business income, would be treated as "active business" income.

Again, the literal meaning of "active business" and the purpose of the incentive dictate opposing results. Using Mr. Justice Gibson's approach, a hobby which had crossed the line into "business" would display "business activity"

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<sup>165</sup> 77 D.T.C. 5115 (F.C.T.D.).

<sup>166</sup> 75 D.T.C. 219 (T.R.B.).

<sup>167</sup> In the *Alberta Companies Act*, *supra* note 150, doctors, lawyers, dentists and accountants remain fully liable for their professional work, and the registration of such a "corporation" terminates upon the death, disentanglement, etc. of the corporation's professional. Granted that the corporation is a fictional entity, but the "professional corporation" seems to be an "artificial fiction", and inadequate to shield its principal from current taxation on all fees at full personal rates.

as well, and fall within the ordinary meaning of "active business." On the other hand, it is unlikely that Parliament intended to encourage sportscar racing, horseracing, writing, prospecting or lottery gambling by means of section 125. Unfortunately, "active business" is too crude a tool to effectively exclude these pleasurable forms of profit production.

#### IV. CONCLUSIONS

Part of the purpose of this article has been to explore and analyse the concept of active business as it has emerged to date. The vagueness and redundancy of the phrase has generated confusion and controversy as to its application, and this has been a preliminary effort to identify the definitional frameworks being used and the validity of each approach. Although the "purpose" and "level of activity" approaches have some superficial attraction, the functional approach, in which active business is assimilated to business as defined in section 248(1) of the Act, is the preferable view, and the one certain to be anointed by time.

The other purpose of the article has been to use business receipts from hobby, professional, property, etc. undertakings to illustrate how inadequate the phrase "active business" is in attaining Parliament's avowed intention of stimulating new and small business. The provision as initially structured would have given the courts guidelines to consider, when asked, to extend the accepted scope of the phrase, and a suitably narrow definition would have emerged. With the alteration of the provision as of its effective date, however, there were no guidelines available, and the wide import of "business" eventually was attributed to "active business," robbing the modifier "active" of meaning. While Parliament ultimately rejected a rigid and narrow scope of application for the small business incentive, it is unlikely that it contemplated or desired a broad definition either.

Since a broad concept of "active business" is reflected in the two court decisions thus far, it is unlikely that reference to the intended purpose of section 125 will be sufficient to effect any change. If Parliament is serious about carving out a tax concession for economically beneficial operations, then it will be necessary to refine the definition of "active business" altogether, or else the credit should be denied to corporations which derive more than a certain portion of their receipts from enumerated sources, reverting in part to the pattern of the personal corporation legislation.

This is not to suggest that explicit statutory description of all of the components of "active business" will resolve the issues conclusively. Many of the issues, especially those concerning income from property, cannot be resolved with any precision because they are dependent upon fact, circumstances, inference and sometimes hidden motives.

